DOT HILL SYSTEMS CORP
Form 424B4
September 18, 2003

QuickLinks -- Click here to rapidly navigate through this document

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

TABLE OF CONTENTS

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

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.

18

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.

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

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.

27

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

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 of our common stock issuable upon exercise of the warrants issued to Sun.

Anti-Takeover Provisions of Delaware Law and Charter Provisions

We are subject to Section 203 of the Delaware General Corporation Law. In general, this statute prohibits a publicly held Delaware corporation from engaging in any business combination with any interested stockholder for a period of 3 years following the date that the stockholder became an interested stockholder unless:

- prior to that date, the board of directors of the corporation approved either the business combination or the transaction that resulted in the stockholder becoming an interested stockholder;
- upon consummation of the transaction that resulted in the stockholder becoming an interested stockholder, the interested stockholder owned at least 85% of the voting stock of the corporation outstanding at the time the transaction commenced, excluding those shares owned by persons who are directors and also officers, and employee stock plans in which employee participants do not have the right to determine confidentially whether shares held subject to the plan will be tendered in a tender or exchange offer; or
- on or subsequent to the date, the business combination is approved by the board of directors and authorized at an annual or special meeting of stockholders, and not by written consent, by the affirmative vote of at least two-thirds of the outstanding voting stock that is not owned by the interested stockholder.

Section 203 defines "business combination" to include:

any merger or consolidation involving the corporation and the interested stockholder;

any sale, transfer, pledge or other disposition involving the interested stockholder of 10% or more of the assets of the corporation;

subject to exceptions, any transaction that results in the issuance or transfer by the corporation of any stock of the corporation to the interested stockholder;

56

transfer by the corporation of any stock of the corporation to the interested stockholder; or

the receipt by the interested stockholder of the benefit of any loans, advances, guarantees, pledges or other financial benefits provided by or through the corporation.

In general, Section 203 defines an interested stockholder as any entity or person beneficially owning 15% or more of the outstanding voting stock of the corporation and any entity or person affiliated with or controlling or controlled by such entity or person.

Our certificate of incorporation and bylaws include a number of provisions that may have the effect of deterring hostile takeovers or delaying or preventing an acquisition of us.

Our bylaws provide that all stockholder actions must be effected at a duly called meeting of holders and not by written consent.

Our bylaws provide that special meetings of the our stockholders may be called only by our chairman of the board of directors, our chief executive officer or our board of directors pursuant to a resolution adopted by a majority of the total number of our authorized directors.

Our certificate of incorporation and bylaws provide for a classified board of directors, in which approximately one-third of our directors would be elected each year. Consequently, any potential acquiror would need to successfully complete two proxy contests in order to take control of our board of directors.

Our bylaws establish procedures, including advance notice procedures, with regard to the nomination of candidates for election as directors and stockholder proposals.

These provisions of the certificate of incorporation and bylaws could discourage potential acquisition proposals and could delay or prevent a change in control.

Stockholder Rights Plan

On May 17, 2003 we adopted a plan to provide certain rights to our stockholders, or a rights plan. Terms of the rights plan provide for a dividend distribution of one preferred share purchase right for each outstanding share of our common stock. The dividend was payable on May 30, 2003 to our stockholders of record on that date. Each such purchase right entitles the registered holder to purchase one one-hundredth of a share of our series A junior participating preferred stock at a price of $50.00, subject to adjustment. Each one one-hundredth of a share of this series of preferred stock has designations and powers, preferences and rights, and qualifications, limitations and restrictions that make its value approximately equal to the value of one share of our common stock. The description and terms of the purchase rights are set forth in a rights agreement, dated as of May 19, 2003 that we entered into with American Stock Transfer & Trust Company, as rights agent, and filed as an exhibit to our current report on Form 8-K filed with the SEC on May 19, 2003.

Transfer Agent and Registrar

The transfer agent and registrar for our common stock is American Stock Transfer & Trust Company. Its address is 59 Maiden Lane, New York, New York 10038 and its telephone number at this location is (212) 936-5100.

UNDERWRITING

Under the terms of an underwriting agreement, which is filed as an exhibit to the registration statement relating to this prospectus, each of Lehman Brothers Inc., Deutsche Bank Securities Inc., RBC Dain Rauscher Inc. and Roth Capital Partners, LLC have severally agreed to purchase from us and the selling stockholders the respective number of shares of common stock opposite their names below:

Underwriters	Number of Shares
Lehman Brothers Inc.	5,000,000
Deutsche Bank Securities Inc.	2,000,000
RBC Dain Rauscher Inc.	2,000,000
Roth Capital Partners, LLC	1,000,000
Total	10,000,000

The underwriting agreement provides that the underwriters' obligation to purchase shares of our common stock depends on the satisfaction of the conditions contained in the underwriting agreement, which include:

- if any shares of our common stock are purchased by the underwriters, then all of the shares of common stock the underwriters agreed to purchase must be purchased;
- the representations and warranties made by us and the selling stockholders to the underwriters are true;
- there is no material change in the financial markets; and
- we and the selling stockholders deliver customary closing documents to the underwriters.

Over-Allotment Option

We and the selling stockholders have granted the underwriters a 30-day option to purchase up to 1,500,000 shares at the public offering price less underwriting discounts and commissions. To the extent that the option is exercised, each underwriter will be obligated, subject to certain conditions, to purchase a number of additional shares proportionate to the underwriter's initial commitment as indicated in the preceding table, and we and the selling stockholders will be obligated, pursuant to the option, to sell these shares to the underwriters.

Commissions and Expenses

The underwriters have advised us and the selling stockholders that the underwriters propose to offer shares of our common stock directly to the public at the public offering price presented on the cover of this prospectus and to selected dealers, who may include the underwriters, at such offering price less a selling concession not in excess of $0.49 per share. The underwriters may allow, and the selected dealers may re-allow, a discount from the concession not in excess of $0.10 per share to other dealers. After the offering, the underwriters may change the public offering price and other offering terms.

The following table summarizes the underwriting discounts and commissions we and the selling stockholders will pay to the underwriters. These amounts are shown assuming both no exercise and full exercise of the underwriters' over-allotment option to purchase up to 1,500,000 additional shares. The

underwriting fee is the difference between the initial price to the public and the amount the underwriters pay us and the selling stockholders for the shares.

	No Exercise	Full Exercise
Per Share	$ 0.814	$ 0.814
Total	$ 8,140,000	$ 9,361,000

We estimate that the total expenses of the offering, including registration, filing and listing fees, printing fees and legal and accounting expenses, but excluding underwriting discounts and commissions, will be approximately $750,000. We have agreed to pay for such expenses incurred in connection with the offering that are customarily paid by the registering company. We will not pay any underwriting discounts or commissions on behalf of any selling stockholder.

Lock-Up Agreements

We have agreed that we will not offer, sell, contract to sell, pledge or otherwise dispose of, directly or indirectly, or file with the SEC a registration statement under the Securities Act relating to, any shares of our common stock or securities convertible into or exchangeable or exercisable for any shares of our common stock (other than shares of our common stock offered in this offering), or publicly disclose the intention to make any such offer, sale, pledge, disposition or filing, without the prior written consent of Lehman Brothers Inc. for a period of 90 days after the date of this prospectus, except issuances pursuant to the exercise of options outstanding on the date hereof, grants of employee stock options pursuant to the terms of a plan in effect on the date hereof, issuances pursuant to the exercise of such options, the filing of registration statements on Form S-8 and amendments thereto in connection with those stock options or our employee stock purchase plans in existence on the date hereof and the issuance of shares or options in acquisitions in which the acquiror of such shares agrees to the foregoing restrictions.

All of the selling stockholders, certain other stockholders and our executive officers and directors have agreed under lock-up agreements that, without the prior written consent of Lehman Brothers Inc., they will not 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 capital stock for a period ending 90 days after the date of this prospectus, other than the common stock sold under this prospectus.

Indemnification

We and the selling stockholders have agreed to indemnify the underwriters against liabilities relating to the offering, including liabilities under the Securities Act and liabilities arising from breaches of the representations and warranties contained in the underwriting agreement, and to contribute to payments that the underwriters may be required to make for these liabilities.

Stabilization, Short Positions and Penalty Bids

The underwriters may engage in over-allotment, stabilizing transactions, syndicate covering transactions, and penalty bids or purchases for the purpose of pegging, fixing or maintaining the price of the common stock, in accordance with Regulation M under the Exchange Act:

Over-allotment involves sales by the underwriter of shares in excess of the number of shares the underwriter is obligated to purchase, which creates a syndicate short position. The short position may be either a covered short position or a naked short position. In a covered short position, the number of shares over-allotted by the underwriter is not greater than the number of shares that they may purchase in the over-allotment option. In a naked short position, the number of shares involved is greater than the number of shares in the over-allotment option. The underwriter may close out any short position by either exercising its over-allotment option and/or purchasing shares in the open market.

Stabilizing transactions permit bids to purchase the underlying security so long as the stabilizing bids do not exceed a specified maximum.

Syndicate covering transactions involve purchases of the common stock in the open market after the distribution has been completed in order to cover syndicate short positions. In determining the source of shares to close out the short position, the underwriter will consider, among other things, the price of shares available for purchase in the open market as compared to the price at which they may purchase shares through the over-allotment option. If the underwriter sells more shares than could be covered by the over-allotment option, which is called a naked short position, the position can only be closed out by buying shares in the open market. A naked short position is more likely to be created if the underwriter is concerned that there could be downward pressure on the price of the shares in the open market after pricing that could adversely affect investors who purchase shares in the offering.

Penalty bids permit the underwriters to reclaim a selling concession from a syndicate member when the common stock originally sold by the syndicate member is purchased in a stabilizing or syndicate covering transaction to cover syndicate short positions.

These stabilizing transactions, syndicate covering transactions and penalty bids may have the effect of raising or maintaining the market price of our common stock or preventing or retarding a decline in the market price of our common stock. As a result, the price of our common stock may be higher than the price that might otherwise exist in the open market. These transactions may be effected on the Nasdaq National Market or otherwise and, if commenced, may be discontinued at any time.

Neither we, the selling stockholders, nor any of the underwriters make any representation or prediction as to the direction or magnitude of any effect that the transactions described above may have on the price of our common stock. In addition, neither we, the selling stockholders, nor the underwriters make any representation that the underwriters will engage in these stabilizing transactions or that any transaction, once commenced, will not be discontinued without notice.

Passive Market Making

In connection with this offering, underwriters and selling group members may engage in passive market making transactions in our common stock on the Nasdaq National Market in accordance with Rule 103 of Regulation M under the Exchange Act during the period before commencement of offerings or sales of common stock and extending through the completion of the distribution. A passive market maker must display its bids at a price not in excess of the highest independent bid of the security. However, if all independent bids are lowered below the passive market maker's bid, that bid must be lowered when specified purchase limits are exceeded.

Stamp Taxes

Purchasers of the shares of our common stock offered by this prospectus may be required to pay stamp taxes and other charges under the laws and practices of the country of purchase, in addition to the offering price listed on the cover of this prospectus. Accordingly, we urge you to consult a tax advisor with respect to whether you may be required to pay those taxes or charges, as well as any other tax consequences that may arise under the laws of the country of purchase.

Electronic Distribution

A prospectus in electronic format may be made available on the Internet sites or through other online services maintained by the underwriters and/or one or more of the selling group members

participating in this offering, or by their affiliates. In those cases, prospective investors may view offering terms online and, depending upon the underwriter or the particular selling group member, prospective investors may be allowed to place orders online. The underwriters may agree with us to allocate a specific number of shares for sale to online brokerage account holders. Any such allocation for online distributions will be made by the underwriters on the same basis as other allocations.

Other than the prospectus in electronic format, the information on the underwriters' or any selling group member's web site and any information contained in any other web site maintained by the underwriter or any selling group member is not part of the prospectus, the accompanying prospectus or the registration statement of which this prospectus forms a part, has not been approved and/or endorsed by us or the underwriters or any selling group member in its capacity as underwriter or selling group member and should not be relied upon by investors.

Relationships

Some of the underwriters and their affiliates have engaged in, are engaging in and may in the future engage in, investment banking and other commercial dealings in the ordinary course of business with us and our affiliates. They have received and may in the future receive customary fees and expenses for these commercial and investment banking transactions.

Other than in connection with this offering, and as otherwise described in this section, we have not, within the 12 month period ended July 31, 2003, entered into any arrangements to obtain investment or financial advisory services by any of the underwriters nor, since that date, have we entered into any arrangements to provide such services in the future.

Roth Capital Partners, LLC, or Roth, was paid placement agent and financial advisory fees for providing services to us in connection with certain transactions consummated by us in December 2002 and March 2003. Specifically, in December 2002, Roth received a cash fee of approximately $0.4 million and a warrant to purchase up to 118,812 shares of our common stock at an exercise price per share equal to $3.25, representing an approximate 8% premium above the then fair market value of our common stock. In March 2003, Roth received a cash fee of approximately $1.2 million and a warrant to purchase up to 183,000 shares of our common stock at an exercise price per share equal to $4.68, the then fair market value of our common stock.

NOTICE TO CANADIAN RESIDENTS

Resale Restrictions

The distribution of the securities in Canada is being made only on a private placement basis exempt from the requirement that we prepare and file a prospectus with the securities regulatory authorities in each province where trades of securities are made. Any resale of the securities in Canada must be made under applicable securities laws which will vary depending on the relevant jurisdiction, and which may require resales to be made under available statutory exemptions or under a discretionary exemption granted by the applicable Canadian securities regulatory authority. Purchasers are advised to seek legal advice prior to any resale of the securities.

Representations of Purchasers

By purchasing securities in Canada and accepting a purchase confirmation, a purchaser is representing to us and the dealer from whom the purchase confirmation is received that:

- the purchaser is entitled under applicable provincial securities laws to purchase the securities without the benefit of a prospectus qualified under those securities laws;
- where required by law, that the purchaser is purchasing as principal and not as agent; and
- the purchaser has reviewed the text in the above under "Resale Restrictions."

Rights of Actions Ontario Purchasers

Under Ontario securities legislation, a purchaser who purchases a security offered by this prospectus during the period of distribution will have a statutory right of action for damages, or while still the owner of the shares, for rescission against us in the event that this prospectus contains a misrepresentation. A purchaser will be deemed to have relied on the misrepresentation. The right of action for damages is exercisable not later than the earlier of 180 days from the date the purchaser first had knowledge of the facts giving rise to the cause of action and three years from the date on which payment is made for the shares. The right of action for rescission is exercisable not later than 180 days from the date on which payment is made for the shares. If a purchaser elects to exercise the right of action for rescission, the purchaser will have no right of action for damages against us. In no case will the amount recoverable in any action exceed the price at which the shares were offered to the purchaser and if the purchaser is shown to have purchased the securities with knowledge of the misrepresentation, we will have no liability. In the case of an action for damages, we will not be liable for all or any portion of the damages that are proven to not represent the depreciation in value of the shares as a result of the misrepresentation relied upon. These rights are in addition to, and without derogation from, any other rights or remedies available at law to an Ontario purchaser. The foregoing is a summary of the rights available to an Ontario purchaser. Ontario purchasers should refer to the complete text of the relevant statutory provisions.

Enforcement of Legal Rights

All of our directors and officers as well as the experts named herein may be located outside of Canada and, as a result, it may not be possible for Canadian purchasers to effect service of process within Canada upon us or those persons. All or a substantial portion of our assets and the assets of those persons may be located outside of Canada and, as a result, it may not be possible to satisfy a judgment against us or those persons in Canada or to enforce a judgment obtained in Canadian courts against us or those persons outside of Canada.

Taxation and Eligibility for Investment

Canadian purchasers of securities should consult their own legal and tax advisors with respect to the tax consequences of an investment in the securities in their particular circumstances and about the eligibility of the securities for investment by the purchaser under relevant Canadian legislation.

LEGAL MATTERS

Cooley Godward LLP, San Diego, California, will pass upon the validity of the issuance of the common stock offered by this prospectus. Certain legal matters will be passed upon for the underwriters by Weil, Gotshal & Manges LLP, Redwood Shores, California.

EXPERTS

The financial statements as of December 31, 2001 and 2002, and for each of the three years in the period ended December 31, 2002, included and incorporated by reference in this prospectus and the related financial statement schedule incorporated by reference in this prospectus have been audited by Deloitte & Touche LLP, independent auditors, as stated in their report appearing herein and their reports which are incorporated by reference herein, and have been so included and incorporated in reliance upon the reports of such firm given upon their authority as experts in accounting and auditing.

WHERE YOU CAN FIND MORE INFORMATION

We file annual, quarterly and current reports, proxy statements and other information with the SEC. The SEC allows us to incorporate by reference the information we file with them, which means that we can disclose important business and financial information to you that is not included in or delivered with this prospectus by referring you to publicly filed documents that contain the omitted information. We provide a list of all documents we incorporate by reference in this prospectus under "Incorporation of Certain Documents by Reference" below.

You may read and copy the information that we incorporate by reference in this prospectus as well as other reports, proxy statements and other information that we file with the SEC at the public reference facility maintained by the SEC at 450 Fifth Street, N.W., Washington, D.C. 20549. Please call the SEC at 1-800-SEC-0330 for further information on the operation of the public reference room. In addition, we are required to file electronic versions of those materials with the SEC through the SEC's EDGAR system. The SEC maintains a web site at *http://www.sec.gov* that contains reports, proxy statements and other information that registrants, such as us, file electronically with the SEC.

Each person to whom a prospectus is delivered may also request a copy of those materials, free of change, by writing us at the following address: Dot Hill Systems Corp., 6305 El Camino Real, Carlsbad, California 92009, Attention: Investor Relations, or by telephoning us at

(760) 931-5500.

You should rely only on the information contained or incorporated by reference in this prospectus. We have not authorized anyone to provide you with different information. If anyone provides you with different or inconsistent information, you should not rely on it. You should not assume that the information contained in this prospectus is accurate as of any date other than the date such information is presented, or, with respect to information incorporated by reference from reports or documents filed with the SEC, as of the date such report or document was filed. We are not making an offer to sell these securities in any jurisdiction where the offer or sale is not permitted.

We have filed with the SEC a registration statement on Form S-3 under the Securities Act covering the securities described in this prospectus. This prospectus does not contain all of the information included in the registration statement, some of which is contained in exhibits included with or incorporated by reference into the registration statement. The registration statement, including the exhibits contained or incorporated by reference therein, can be read at the SEC's website or at the

SEC offices referred to above. Any statement made in this prospectus concerning the contents of any contract, agreement or other document is only a summary of the actual contract, agreement or other document. If we have filed or incorporated by reference any contract, agreement or other document as an exhibit to the registration statement, you should read the exhibit for a more complete understanding of the document or matter involved. Each statement regarding a contract, agreement or other document is qualified in its entirety by reference to the actual document.

INCORPORATION OF CERTAIN DOCUMENTS BY REFERENCE

The SEC allows us to "incorporate by reference" into this prospectus the information we file with the SEC in other documents, which means that we can disclose important information to you by referring you to those documents. The information incorporated by reference is considered to be a part of this prospectus, and information that we file later with the SEC will automatically update and supersede this information. You will be deemed to have notice of all information incorporated by reference in this prospectus as if that information were included in this prospectus. We incorporate by reference the documents listed below and any future filings we make with the SEC under Sections 13(a), 13(c), 14, or 15(d) of the Exchange Act, until the offering of securities by this prospectus is completed:

- our Quarterly Report on Form 10-Q for the quarter ended June 30, 2003 filed with the SEC on August 7, 2003;
- our Quarterly Report on Form 10-Q for the quarter ended March 31, 2003 filed with the SEC on May 15, 2003;
- our Annual Report on Form 10-K/A for the fiscal year ended December 31, 2002 filed with the SEC on April 25, 2003; and
- our Current Reports on Form 8-K filed with the SEC on September 18, 2003, September 5, 2003, August 12, 2003, July 23, 2003, June 4, 2003, May 19, 2003, May 7, 2003, May 2, 2003, April 23, 2003, March 19, 2003, January 30, 2003 and January 14, 2003.

DOT HILL SYSTEMS CORP. AND SUBSIDIARIES

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

Page

DOT HILL SYSTEMS CORP. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(UNAUDITED IN THOUSANDS, EXCEPT PER SHARE INFORMATION)

	December 31, 2002	June 30, 2003
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 10,082	$ 20,632
Restricted cash	2,000	
Short-term investments		10,045
Accounts receivable, net of allowance of $751 and $825	6,304	14,803
Inventories	6,959	3,495
Prepaid expenses and other	2,313	3,314
Total current assets	27,658	52,289
Property and equipment, net	4,110	4,400
Other assets	460	1,405
Total assets	$ 32,228	$ 58,094
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Accounts payable	$ 14,446	$ 24,587
Accrued compensation	1,754	2,619

	December 31, 2002	June 30, 2003
Accrued expenses	1,614	2,539
Deferred revenue	1,110	1,362
Income taxes payable	1,020	942
Short-term debt	4,552	
Current portion of restructuring accrual	407	384
Total current liabilities	24,903	32,433
Restructuring accrual, net of current portion	1,179	919
Borrowings under lines of credit	275	266
Other long-term liabilities	86	70
Total liabilities	26,443	33,688
Contingencies (Note 11)		
Stockholders' Equity:		
Preferred stock, $0.001 par value, 10,000 shares authorized, 6 and 0 shares issued and outstanding at December 31, 2002 and June 30, 2003, respectively		
Common stock, $0.001 par value, 100,000 shares authorized, 25,172 and 32,273 shares issued and outstanding at December 31, 2002 and June 30, 2003, respectively	25	32
Additional paid-in capital	109,562	127,405
Deferred compensation	(48)	(38)
Accumulated other comprehensive loss	(318)	(511)
Accumulated deficit	(103,436)	(102,482)
Total stockholders' equity	5,785	24,406
Total liabilities and stockholders' equity	$ 32,228	$ 58,094

See accompanying notes to condensed consolidated financial statements.

DOT HILL SYSTEMS CORP. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

AND COMPREHENSIVE OPERATIONS

(UNAUDITED IN THOUSANDS, EXCEPT PER SHARE INFORMATION)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2002	2003	2002	2003
Net Revenue	$ 11,206	$ 48,428	$ 22,096	$ 78,950

	Three Months Ended June 30,		Six Months Ended June 30,	
Cost of Goods Sold	10,933	38,415	19,459	63,400
Gross Profit	273	10,013	2,637	15,550
Operating Expenses:				
Sales and marketing	8,636	3,391	13,495	6,812
Research and development	2,517	2,841	4,867	4,897
General and administrative	1,490	1,610	2,814	3,071
Total operating expenses	12,643	7,842	21,176	14,780
Operating Income (Loss)	(12,370)	2,171	(18,539)	770
Other Income (Expense):				
Interest income	188	97	287	123
Interest expense	(33)	(23)	(66)	(70)
Gain (loss) on foreign currency transactions, net	31	320	(25)	302
Other income (expense), net	2	6	(19)	(18)
Total other income, net	188	400	177	337
Income (Loss) Before Income Taxes	(12,182)	2,571	(18,362)	1,107
Income Tax Benefit (Expense)	3,300	(11)	3,300	(11)
Net Income (Loss)	$ (8,882)	$ 2,560	$ (15,062)	$ 1,096
Net Income (Loss) Attributable to Common Stockholders:				
Net income (loss)	$ (8,882)	$ 2,560	$ (15,062)	$ 1,096
Dividends on preferred stock		36		141
Net income (loss) attributable to common stockholders	$ (8,882)	$ 2,524	$ (15,062)	$ 955
Net Income (Loss) Per Share:				
Basic	$ (0.36)	$ 0.08	$ (0.61)	$ 0.03
Diluted	$ (0.36)	$ 0.07	$ (0.61)	$ 0.03
Weighted Average Shares Used to Calculate Net Income (Loss) Per Share:				
Basic	24,913	31,576	24,854	28,877
Diluted	24,913	35,669	24,854	32,954

	Three Months Ended June 30,		Six Months Ended June 30,	
Comprehensive Operations:				
Net income (loss)	$ (8,882)	$ 2,560	$ (15,062)	$ 1,096
Foreign currency translation adjustments	(167)	(92)	(53)	(177)
Net unrealized loss on short-term investments	(71)	(16)	(150)	(16)
Comprehensive income (loss)	$ (9,120)	$ 2,452	$ (15,265)	$ 903

See accompanying notes to condensed consolidated financial statements.

DOT HILL SYSTEMS CORP. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(UNAUDITED IN THOUSANDS)

	Six Months Ended June 30,	
	2002	**2003**
Cash Flows From Operating Activities:		
Net income (loss)	$ (15,062)	$ 1,096
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation and amortization	693	1,042
Loss on disposal of property and equipment		27
Provision for doubtful accounts and note receivable	468	74
Stock-based sales and marketing expenses	3,647	
(Gain) loss on sales of short-term investments	(71)	1
Stock-based compensation expense	26	10
Changes in operating assets and liabilities:		
Accounts receivable	(1,057)	(8,573)
Inventories	4,954	3,464
Prepaid expenses and other assets	254	(1,946)
Accounts payable	756	10,141
Accrued compensation and other expenses	(180)	1,790
Deferred revenue	(157)	252
Income taxes payable	(2,388)	(78)
Restructuring accrual	(785)	(283)
Other liabilities	24	(16)
Net cash provided by (used in) operating activities	(8,878)	7,001

	Six Months Ended June 30,	
Cash Flows From Investing Activities:		
Purchases of property and equipment	(348)	(1,359)
Sales of short-term investments	8,637	1,530
Purchases of short-term investments	(44)	(11,592)
Net cash provided by (used in) investing activities	8,245	(11,421)
Cash Flows From Financing Activities:		
(Increase) decrease in restricted cash and investments	(7,268)	2,000
Proceeds from bank and other borrowings	16,261	22,848
Payments on bank and other borrowings	(9,005)	(27,409)
Proceeds from issuance of common stock and stock warrants, net of issuance costs		16,543
Proceeds from exercise of stock options		958
Proceeds from sale of stock to employees	133	348
Dividends paid to preferred stockholders		(141)
Net cash provided by financing activities	121	15,147
Effect of Exchange Rate Changes on Cash	(53)	(177)
Net Increase (Decrease) in Cash and Cash Equivalents	(565)	10,550
Cash and Cash Equivalents, beginning of period	7,785	10,082
Cash and Cash Equivalents, end of period	$ 7,220	$ 20,632
Supplemental Disclosures of Cash Flow Information:		
Cash paid for interest	$ 54	$ 61
Cash paid for income taxes	$ 51	$ 95

See accompanying notes to condensed consolidated financial statements.

DOT HILL SYSTEMS CORP. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

1. Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared by Dot Hill Systems Corp. ("Dot Hill", "we", "our" or "us") pursuant to the rules and regulations of the Securities and Exchange Commission (the "SEC"). Accordingly, they do not include all of the information and disclosures required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, all adjustments and reclassifications considered necessary for a fair and comparable presentation have been included and are of a normal recurring nature. Certain reclassifications have been made to the prior year financial statements to conform with the current year financial statement presentation. 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/A for the year ended December 31, 2002. Operating results for the six months ended June 30, 2003 are not necessarily indicative of the results that may be expected for the year ending December 31, 2003.

The preparation of our financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, and disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates under different assumptions and conditions.

2. 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.

3. Stock-Based Compensation

We account for stock-based employee compensation using the intrinsic value method prescribed in Accounting Principles Board ("APB") Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations for all periods presented. Accordingly, compensation cost for stock options issued to employees is measured as the excess, if any, of the fair value of our stock at the date of grant over the amount an employee must pay to acquire the stock.

Had compensation cost for our stock option awards been determined based upon the fair value at the date of grant in accordance with SFAS No. 123, *Accounting for Stock-Based Compensation*, our net income (loss) and basic and diluted net income (loss) per share would have been the following amounts (in thousands, except per share information):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2002	2003	2002	2003
Net income (loss) attributable to common stockholders as reported	$ (8,882)	$ 2,524	$ (15,062)	$ 955
Stock-based employee compensation expense included in reported net income (loss) attributable to common stockholders	13	5	26	10
Stock-based employee compensation expense determined under fair value based method	(306)	(530)	(1,077)	(1,304)
Pro forma net income (loss) attributable to common stockholders	$ (9,175)	$ 1,999	$ (16,133)	$ (339)

	Three Months Ended June 30,		Six Months Ended June 30,	
Basic net income (loss) per share:				
As reported	$ (0.36)	$ 0.08	$ (0.61)	$ 0.03
Pro forma	$ (0.37)	$ 0.06	$ (0.65)	$ (0.01)
Diluted net income (loss) per share:				
As reported	$ (0.36)	$ 0.07	$ (0.61)	$ 0.03
Pro forma	$ (0.37)	$ 0.06	$ (0.65)	$ (0.01)

The fair value of each option grant was estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions:

	Six Months Ended June 30,	
	2002	2003
Risk free interest rate	3.03%	2.52%
Expected dividend yield		
Expected life	5 years	5 years
Expected volatility	105%	82%

4. Earnings Per Share

Basic net income (loss) per share is calculated by dividing net income (loss) attributable to common stockholders by the weighted average number of common shares outstanding during the period. Diluted net income (loss) per share reflects the potential dilution of securities by including other common stock equivalents, such as stock options, stock warrants and convertible preferred stock, in the weighted average number of common shares outstanding for a period, if dilutive.

The following table sets forth a reconciliation of the basic and diluted number of weighted average shares outstanding used in the calculation of net income (loss) per share (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2002	2003	2002	2003
Shares used in computing basic net income (loss) per share	24,913	31,576	24,854	28,877
Dilutive effect of stock options and stock warrants		3,464		2,843
Dilutive effect of convertible preferred stock		629		1,234
Shares used in computing diluted net income (loss) per share	24,913	35,669	24,854	32,954

For the three months ended June 30, 2003 and 2002, outstanding options to purchase 290,437 and 3,581,736 shares of our common stock, respectively, and outstanding warrants to purchase 0 and 1,239,527 shares of our common stock, respectively, were not included in the calculation of diluted net income (loss) per share because their effect was antidilutive.

For the six months ended June 30, 2003 and 2002, outstanding options to purchase 480,691 and 3,581,736 shares of our common stock, respectively, and outstanding warrants to purchase 0 and 1,239,527 shares of our common stock, respectively, were not included in the calculation of diluted net income (loss) per share because their effect was antidilutive.

5. Short-Term Investments

The following table summarizes our short-term investments as of June 30, 2003 (in thousands):

	Cost	Net Unrealized Losses	Net Unrealized Gains	Fair Value
U.S. Government securities	$ 7,137	$ 31	$ 7	$ 7,113
Commercial paper	2,924		8	2,932
	$ 10,061	$ 31	$ 15	$ 10,045

The cost and fair value at June 30, 2003 by contractual maturity are shown below (in thousands). Expected maturities will differ from contractual maturities because the issuers of the securities may have the right to prepay obligations without prepayment penalties.

	Cost	Fair Value
Due in one year or less	$ 5,492	$ 5,477
Due after one year through two years	4,569	4,568
	$ 10,061	$ 10,045

As of December 31, 2002, we did not have any securities classified as short-term investments.

6. Inventories

Inventories are stated at the lower of cost (first-in, first-out) or market value. The following is a summary of inventories (in thousands):

	December 31, 2002	June 30, 2003
Purchased parts and materials	$ 4,509	$ 1,766
Work-in-process	120	55
Finished goods	2,330	1,674
	$ 6,959	$ 3,495

During the six months ended June 30, 2003 and 2002, we recorded inventory write-downs of $0.5 million and $3.5 million, respectively. During the three months ended June 30, 2003 and 2002, we recorded inventory write-downs of $0.4 million and $3.1 million, respectively.

7. Product Warranties

We generally extend to our customers the warranties provided to us by our suppliers and, accordingly, the majority of our warranty obligations to customers are covered by supplier warranties. For warranty costs not covered by our suppliers, we provide for estimated warranty costs in the period the revenue is recognized. There can be no assurance that our suppliers will continue to provide such warranties to us in the future, which could have a material adverse effect on our operating results and financial condition. Our warranty cost activity for the six months ended June 30 is as follows (in thousands):

Six Months Ended June 30,	Accrued Warranty Costs at Beginning of Period	Charged to Operations	Deductions for Costs Incurred	Accrued Warranty Costs at End of Period
2003	$ 336	$ 394	$ (394)	$ 336
2002	316	679	(679)	316

8. Restructurings

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 "March 2001 Restructuring"). 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 (the "June 2001 Restructuring"). 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. The facility closures and related costs consist of lease termination costs for five sales offices and closure of the New York City location.

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

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

The following is a summary of restructuring activity recorded during the period from January 1, 2002 to June 30, 2003 (in thousands):

March 2001 Restructuring

	Accrued Restructuring Expenses at January 1, 2002	Additional Restructuring Expenses in 2002	Amounts Utilized in 2002	Accrued Restructuring Expenses at December 31, 2002	Amounts Utilized in 2003	Accrued Restructuring Expenses at June 30, 2003

Employee termination costs	$ 2	$	$ (2)	$	$	$
Facility closures and related costs	394	693	(426)	661	(152)	509
Total	$ 396	$ 693	$ (428)	$ 661	$ (152)	$ 509

June 2001 Restructuring

	Accrued Restructuring Expenses at January 1, 2002	Additional Restructuring Expenses in 2002	Amounts Utilized in 2002	Accrued Restructuring Expenses at December 31, 2002	Amounts Utilized in 2003	Accrued Restructuring Expenses at June 30, 2003
Facility closures and related costs	$ 845	$ 857	$ (777)	$ 925	$ (131)	$ 794

We believe that there are no unresolved issues or additional liabilities that may result in a significant adjustment to restructuring expenses accrued as of June 30, 2003.

9. Stockholders' Equity

On May 17, 2003 we adopted a plan to provide certain rights to our stockholders, or a rights plan. Terms of the rights plan provide for a dividend distribution of one preferred share purchase right for each outstanding share of our common stock. The dividend was payable on May 30, 2003 to our stockholders of record on that date. Each such purchase right entitles the registered holder to purchase one one-hundredth of a share of our Series A Junior Participating Preferred Stock at a price of $50.00, subject to adjustment. Each one one-hundredth of a share of this series of preferred stock has designations and powers, preferences and rights, and qualifications, limitations and restrictions that make its value approximately equal to the value of one share of our common stock.

During March 2003, we raised net proceeds of approximately $16.8 million in a private placement of 4,750,000 shares of our common stock at a price of $3.75 per share. The shares in the private placement were sold at a price per share that was approximately 14% less than the five-day volume weighted average price of our common stock. We agreed to sell the shares in the private placement at a discount to the market price because the purchasers could not resell the shares to the public until the resale was registered. In connection with the private placement, we granted a warrant to the placement agent to purchase 183,000 shares of our common stock for $4.50 per share.

During December 2002, we received gross proceeds of $6.0 million from the sale of 6,000 shares of preferred stock and warrants in a private placement. The preferred stock carried a 7% cumulative dividend. On May 1, 2003, we converted all of the outstanding shares of preferred stock into 1,846,152 shares of our common stock at a per share price of $3.25. The warrants granted to the holders of the preferred stock entitle them to purchase an aggregate of 369,229 shares of our common stock at a per share price of $3.25. The warrants terminate upon the earlier of December 19, 2007 or our consummation of certain acquisition transactions.

10. Income Taxes

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.

11. Legal Matters

We are subject to various legal proceedings and claims, asserted or unasserted, which arise from time to time in the ordinary course of business. The outcome of such 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.

12. Segments and Geographic Information

Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by our chief operating decision-maker, or decision making group, in deciding how to allocate resources and in assessing performance. Our chief operating decision-maker is the Chief Executive Officer. Our operating segments are managed separately because each segment represents a strategic business unit that offers different products or services.

Our operating segments are organized on the basis of products and services. We have identified operating segments that consist of our SANnet family of systems, legacy and other and services. We currently evaluate performance based on stand-alone segment revenue and gross margin. Because we do not currently maintain information regarding operating income at the operating segment level, such information is not presented.

We previously also maintained and disclosed information by market segment, which consisted of e-commerce, telecommunications and service providers, or xSPs; government; and commercial and

other customers. In 2001, we began to focus on indirect sales through channel partners regardless of the market segment served by those channel partners. In May 2002, we signed a key agreement with a particular channel partner, and that partner began to ship product to its own customers during October 2002. Sales to that channel partner accounted for approximately 62% of our revenue during the fourth quarter of 2002, approximately 75% of our revenue during the first quarter of 2003 and approximately 85% of our revenue during the quarter ended June 30, 2003. We have limited visibility into the type of market segments to which that channel partner, and many other channel partners, sell, and therefore we have no way to identify or track revenue generated by those channel partners by market segment. Going forward, we expect sales to channel partners to increase. Therefore, we have ceased to disclose information by market segment.

Information concerning revenue by product and service is as follows (in thousands):

	SANnet Family	Legacy and Other	Services	Total
Three months ended:				
June 30, 2003:				
Net revenue	$ 46,174	$ 1,258	$ 996	$ 48,428
Gross profit (loss)	$ 11,213	$ (1,648)	$ 448	$ 10,013
June 30, 2002:				
Net revenue	$ 8,543	$ 2,046	$ 617	$ 11,206
Gross profit (loss)	$ 2,660	$ (2,404)	$ 17	$ 273
Six months ended:				
June 30, 2003:				
Net revenue	$ 74,103	$ 3,117	$ 1,730	$ 78,950
Gross profit (loss)	$ 17,975	$ (3,137)	$ 712	$ 15,550
June 30, 2002:				
Net revenue	$ 16,027	$ 4,690	$ 1,379	$ 22,096
Gross profit (loss)	$ 4,947	$ (2,364)	$ 54	$ 2,637

Information concerning operating assets by product and service, derived by specific identification for assets related to specific segments and an allocation based on segment volume for assets related to multiple segments, is as follows (in thousands):

SANnet Family	Legacy and Other	Services	Total

	SANnet Family		Legacy and Other		Services		Total
As of:							
June 30, 2003	$	54,030	$	1,646	$	2,418	$ 58,094
December 31, 2002	$	23,590	$	3,033	$	5,605	$ 32,228

Information concerning principal geographic areas in which we operate is as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2002	2003	2002	2003
Net revenue:				
United States	$ 7,053	$ 45,725	$ 14,110	$ 73,868
Europe	3,367	1,694	6,362	3,324
Asia	786	1,009	1,624	1,758
	$ 11,206	$ 48,428	$ 22,096	$ 78,950
Operating income (loss):				
United States	$ (12,234)	$ 1,816	$ (18,394)	$ 691
Europe	(46)	59	38	(165)
Asia	(90)	296	(183)	244
	$ (12,370)	$ 2,171	$ (18,539)	$ 770

Net revenue is recorded in the geographic area in which the sale is originated.

13. Sun Microsystems Loan Agreement

On October 24, 2002, we entered into a loan and security agreement with Sun Microsystems, Inc. ("Sun"), pursuant to which Sun loaned us approximately $4.5 million. The loan was secured by all of our assets. The loan was subject to a fixed interest rate of 2.0% per annum and due to be repaid no later than June 30, 2003. We repaid all principal and interest due under the loan and terminated our loan and security agreement with Sun during the first quarter of 2003.

INDEPENDENT AUDITORS' REPORT

To the Board of Directors and Stockholders of
Dot Hill Systems Corp.:

We have audited the accompanying consolidated balance sheets of Dot Hill Systems Corp. and subsidiaries (the "Company") as of December 31, 2001 and 2002, and the related consolidated statements of operations and comprehensive operations, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2002. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Dot Hill Systems Corp. and subsidiaries as of December 31, 2001 and 2002, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2002, in conformity with accounting principles generally accepted in the United States of America.

/s/ DELOITTE & TOUCHE LLP

San Diego, California
March 17, 2003

DOT HILL SYSTEMS CORP. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

AS OF DECEMBER 31, 2001 AND 2002

(IN THOUSANDS, EXCEPT PER SHARE INFORMATION)

	2001	2002
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 7,785	$ 10,082
Short-term investments and restricted cash	8,672	2,000
Accounts receivable, net of allowance of $1,113 and $751	8,198	6,304
Inventories	13,876	6,959
Prepaid expenses and other	2,438	2,313
Total current assets	40,969	27,658
Property and equipment, net	3,520	4,110
Note receivable, net	1,242	30
Other assets	460	430
Total assets	$ 46,191	$ 32,228
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Accounts payable	$ 5,221	$ 14,446
Accrued compensation	1,728	1,754
Accrued expenses	2,240	1,614
Deferred revenue	1,441	1,110
Income taxes payable	3,266	1,020
Short-term debt		4,552
Current portion of restructuring accrual	1,241	407

	2001	2002
Total current liabilities	15,137	24,903
Restructuring accrual, net of current portion		1,179
Borrowings under lines of credit	330	275
Other long-term liabilities	113	86
Total liabilities	15,580	26,443
Commitments and Contingencies (Note 16)		
Stockholders' Equity:		
Preferred stock, $0.001 par value, 10,000 shares authorized, 6 shares issued and outstanding at December 31, 2002		
Common stock, $0.001 par value, 100,000 shares authorized, 24,791 and 25,172 shares issued and outstanding at December 31, 2001 and 2002, respectively	25	25
Additional paid-in capital	99,467	109,562
Accumulated other comprehensive loss	(204)	(318)
Deferred compensation		(48)
Accumulated deficit	(68,677)	(103,436)
Total stockholders' equity	30,611	5,785
Total liabilities and stockholders' equity	$ 46,191	$ 32,228

See accompanying notes to consolidated financial statements.

DOT HILL SYSTEMS CORP. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE OPERATIONS

FOR THE YEARS ENDED DECEMBER 31, 2000, 2001 AND 2002

(IN THOUSANDS, EXCEPT PER SHARE INFORMATION)

	2000	2001	2002
Net Revenue	$ 121,197	$ 56,277	$ 46,936
Cost of Goods Sold	77,730	44,818	45,444
Gross Profit	43,467	11,459	1,492
Operating Expenses:			
Sales and marketing	31,747	23,717	22,513
Research and development	8,798	6,673	10,043
General and administrative	6,891	4,533	5,150
Restructuring expenses		4,905	1,550

	2000	2001	2002
Total operating expenses	47,436	39,828	39,256
Operating Loss	(3,969)	(28,369)	(37,764)
Other Income (Loss):			
Interest income	2,149	1,013	410
Interest expense	(53)	(107)	(248)
Gain (loss) on foreign currency transactions, net	(6)	52	143
Other income (expense), net	739	(657)	39
Total other income, net	2,829	301	344
Loss Before Income Taxes	(1,140)	(28,068)	(37,420)
Income Tax Benefit (Provision)	192	(15,323)	3,117
Net Loss	$ (948)	$ (43,391)	$ (34,303)
Net Loss Attributable to Common Stockholders:			
Net loss	$ (948)	$ (43,391)	$ (34,303)
Dividends on preferred stock			(16)
Beneficial conversion feature of preferred stock			(440)
Net loss attributable to common stockholders	$ (948 0.9	1.0	0.1

Comprehensive income attributable to The Timken Company	**$ 62.6**	**$ 62.6**	**$ —**	$ 37.3	$37.1	$(0.2)

	Nine Months Ended					
	September 30, 2017			September 30, 2016		
	Previous Accounting Method	**As Reported**	**Effect of Accounting Change**	As Previously Reported	Revised	Effect of Accounting Change
Net Income	**$156.9**	**$ 174.2**	**$ 17.3**	$128.8	$148.0	$ 19.2
Foreign currency translation adjustments	**42.8**	**42.8**	**—**	(1.4)	5.2	6.6
Pension and postretirement liability adjustment	**17.5**	**0.2**	**(17.3)**	27.0	1.2	(25.8)
Other comprehensive income, net of tax	**56.1**	**38.8**	**(17.3)**	24.0	4.8	(19.2)
Comprehensive Income, net of tax	**213.0**	**213.0**	**—**	152.8	152.8	—
Less: comprehensive income attributable to noncontrolling interest	**1.9**	**1.9**	**—**	2.1	2.2	0.1
Comprehensive income attributable to The Timken Company	**$211.1**	**$ 211.1**	**$ —**	$150.7	$150.6	$ (0.1)

5

Table of Contents

Consolidated Balance Sheets:

	September 30, 2017			December 31, 2016		
	Previous Accounting Method	**As Reported**	**Effect of Accounting Change**	As Previously Reported	Revised	Effect of Accounting Change
Inventories, net	**$679.6**	**$687.5**	**$ 7.9**	$545.8	$553.7	$ 7.9
Total current assets	**1,466.4**	**1,474.3**	**7.9**	1,204.0	1,211.9	7.9
Deferred income taxes	**50.9**	**47.9**	**(3.0)**	54.4	51.4	(3.0)
Total other assets	**1,050.1**	**1,047.1**	**(3.0)**	749.9	746.9	(3.0)
Total assets	**3,358.7**	**3,363.6**	**4.9**	2,758.3	2,763.2	4.9
Earnings invested in the business	**1,622.2**	**1,400.2**	**(222.0)**	1,528.6	1,289.3	(239.3)
Accumulated other comprehensive loss	**(267.8)**	**(41.0)**	**226.8**	(322.0)	(77.9)	244.1
Total shareholders' equity	**1,418.2**	**1,423.0**	**4.8**	1,274.9	1,279.7	4.8
Noncontrolling interest	**32.8**	**32.9**	**0.1**	31.1	31.2	0.1
Total equity	**1,451.0**	**1,455.9**	**4.9**	1,306.0	1,310.9	4.9
Total liabilities and shareholders' equity	**$3,358.7**	**$3,363.6**	**$ 4.9**	$2,758.3	$2,763.2	$ 4.9

Consolidated Statements of Cash Flows:

	Nine Months Ended					
	September 30, 2017			September 30, 2016		
	Previous Accounting Method	**As Reported**	**Effect of Accounting Change**	As Previously Reported	Revised	Effect of Accounting Change
Net income attributable to The Timken Company	**$156.9**	**$ 174.2**	**$ 17.3**	$128.5	$147.7	$ 19.2
Deferred income tax (benefit) provision	**(1.7)**	**7.5**	**9.2**	(0.1)	4.6	4.7
Pension and other postretirement expense	**39.1**	**12.6**	**(26.5)**	38.4	14.5	(23.9)

6

Table of Contents

Note 3 - Recent Accounting Pronouncements

New Accounting Guidance Adopted:

In March 2016, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2016-09, "Compensation - Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting." ASU 2016-09 simplifies various aspects of the accounting for stock-based payments. The simplifications include:

a. recording all tax effects associated with stock-based compensation through the income statement, as opposed to recording certain amounts in other paid-in capital, which eliminates the requirements to calculate a “windfall pool”;
b. allowing entities to withhold shares to satisfy the employer’s statutory tax withholding requirement up to the highest marginal tax rate applicable to employees rather than the employer’s minimum statutory rate, without requiring liability classification for the award;
c. modifying the requirement to estimate the number of awards that will ultimately vest by providing an accounting policy election to either estimate the number of forfeitures or recognize forfeitures as they occur;
d. changing certain presentation requirements in the statement of cash flows, including removing the requirement to present excess tax benefits as an inflow from financing activities and an outflow from operating activities and requiring the cash paid to taxing authorities arising from withheld shares to be classified as a financing activity; and
e. amending the assumed proceeds from applying the treasury stock method when computing earnings per share to exclude the amount of excess tax benefits that would be recognized in additional paid-in capital.

On January 1, 2017, the Company adopted the provisions of ASU 2016-09. The presentation of the Consolidated Statement of Cash Flows for shares surrendered by employees to meet the minimum statutory withholding requirement was applied retrospectively. As a result of the adoption of ASU 2016-09, $1.6 million was reclassified from the other accrued expenses line in the operating activities section of the Consolidated Statement of Cash Flows to the shares surrendered for taxes line in the financing activities section for the first nine months of 2016.

In addition, the adoption of ASU 2016-09 resulted in the Company making an accounting policy election to change how it will recognize the number of stock awards that will ultimately vest. In the past, the Company applied a forfeiture rate to shares granted. With the adoption of ASU 2016-09, the Company will recognize forfeitures as they occur. This change resulted in the Company making a cumulative effect change to retained earnings of $0.9 million. For additional information, refer to *Note 10 - Equity* for the disclosure of the cumulative effect change. In addition, the Company began recording the tax effects associated with stock-based compensation through the income statement on a prospective basis, which resulted in a tax benefit of $1.9 million for the first nine months of 2017. Finally, the Company adjusted dilutive shares to remove the excess tax benefits from the calculation of earnings per share on a prospective basis. The revised calculation is more dilutive, but it did not change earnings per share for prior years.

In July 2015, the FASB issued ASU 2015-11, "Inventory (Topic 330): Simplifying the Measurement of Inventory." ASU 2015-11 requires inventory to be measured at the lower of cost and net realizable value, which is defined as the estimated selling price in the ordinary course of business less reasonably predictable costs of completion, disposal and transportation. Under existing guidance, net realizable value is one of several acceptable measures of market value that could be used to measure inventory at the lower of cost or market and, as such, the new guidance reduces the complexity in the measurement. On January 1, 2017, the Company adopted the provisions of ASU 2015-11 on a prospective basis. The adoption of ASU 2015-11 did not have a material impact on the Company's results of operations or financial condition. For our disclosures related to inventories, refer to *Note 5 - Inventories*.

7

New Accounting Guidance Issued and Not Yet Adopted:

In August 2017, the FASB issued ASU 2017-12, "Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities", which impacts both designation and measurement guidance for qualifying hedging relationships and the presentation of hedge results. ASU 2017-12 amends and clarifies the requirements to qualify for hedge accounting, removes the requirement to recognize changes in fair value from certain hedges in current earnings, and specifies the presentation of changes in fair value in the income statement for all hedging instruments. ASU 2017-02 is effective for public companies for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. Early adoption is permitted, including in any interim period for which financial statements have not yet been issued, but the effect of adoption is required to be reflected as of the beginning of the fiscal year of adoption. The Company is currently evaluating the effect that the adoption of ASU 2017-12 will have on the Company's results of operations and financial condition.

In May 2017, the FASB issued ASU 2017-09, "Compensation - Stock Compensation (Topic 718): Scope of Modification Accounting." ASU 2017-09 provides clarity on which changes to the terms or conditions of share-based payment awards require entities to apply the modification accounting provisions required in Topic 718. ASU 2017-09 is effective for public companies for annual reporting periods beginning after December 15, 2017, with early adoption permitted, including adoption in any interim period for which financial statements have not yet been issued. The Company does not expect that the adoption of ASU 2017-09 will have a material impact on the Company's results of operations and financial condition, as the Company does not anticipate future modifications of share-based payment awards.

In March 2017, the FASB issued ASU 2017-07, “Compensation - Retirement Benefits (Topic 715): Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost.” ASU 2017-07 impacts where the components of net benefit cost are presented within an entity’s income statement. Service cost will be included in other employee compensation costs within operating income and is the only component that may be capitalized when applicable. The other components of net periodic benefit cost will be presented separately outside of operating income. ASU 2017-07 is effective for public companies for annual reporting periods beginning after December 15, 2017 and interim periods within that reporting period. Early adoption is permitted as of the beginning of an annual reporting period for which financial statements have not been issued or made available for issuance. Our initial assessment has indicated that the adoption of ASU 2017-07 will result in the reclassification of certain amounts out of "Cost of products sold" and "Selling, general and administrative ("SG&A") expenses" into "Other expense, net" in the Consolidated Statement of Income. Also, the adoption of this standard will result in the reclassification of certain amounts from "Cost of products sold" and "SG&A expenses" for the Mobile Industries and Process Industries segments into Corporate "Other expense, net". The amounts impacted may be material. The Company is currently performing further analysis on the effect that the adoption of ASU 2017-07 will have on the Company's results of operations.

In January 2017, the FASB issued ASU 2017-04, “Intangibles - Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment.” Prior to the issuance of the new accounting guidance, entities first assessed qualitative factors to determine whether a two-step goodwill impairment test was necessary. When entities bypassed or failed the qualitative analysis, they were required to apply a two-step goodwill impairment test. Step 1 compared a reporting unit’s fair value to its carrying amount to determine if there is a potential impairment. If the carrying amount of a reporting unit exceeds its fair value, Step 2 was required to be completed. Step 2 involved determining the implied fair value of goodwill and comparing it to the carrying amount of that goodwill to measure the impairment loss, if any. ASU 2017-04 eliminates Step 2 of the current goodwill impairment test. ASU 2017-04 will require that a goodwill impairment loss be measured at the amount by which a reporting unit's carrying amount exceeds its fair value, not to exceed the carrying amount of goodwill. ASU 2017-04 is effective for public companies for years beginning after December 15, 2019, with early adoption permitted, and must be applied prospectively. The Company is currently evaluating the effect that the adoption of ASU 2017-04 will have on the Company's results of operations and financial condition.

Table of Contents

In June 2016, the FASB issued ASU 2016-13, "Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments." ASU 2016-13 changes how entities will measure credit losses for most financial assets and certain other instruments that are not measured at fair value through net income. The new guidance will replace the current incurred loss approach with an expected loss model. The new expected credit loss impairment model will apply to most financial assets measured at amortized cost and certain other instruments, including trade and other receivables, loans, held-to-maturity debt instruments, net investments in leases, loan commitments and standby letters of credit. Upon initial recognition of the exposure, the expected credit loss model requires entities to estimate the credit losses expected over the life of an exposure (or pool of exposures). The estimate of expected credit losses should consider historical information, current information and reasonable and supportable forecasts, including estimates of prepayments. Financial instruments with similar risk characteristics should be grouped together when estimating expected credit losses. ASU 2016-13 does not prescribe a specific method to make the estimate, so its application will require significant judgment. ASU 2016-13 is effective for public companies in fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. The Company is currently evaluating the effect that the adoption of ASU 2016-13 will have on the Company's results of operations and financial condition.

In February 2016, the FASB issued ASU 2016-02, "Leases (Topic 842)." ASU 2016-02 was issued to increase transparency and comparability among entities by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about lease arrangements. ASU 2016-02 is effective for public companies for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. The Company is currently evaluating the effect that the adoption of ASU 2016-02 will have on the Company's results of operations and financial condition.

In May 2014, the FASB issued ASU 2014-09, "Revenue from Contracts with Customers (Topic 606)." ASU 2014-09 introduces a new five-step revenue recognition model in which an entity should recognize revenue to depict the transfer of goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. ASU 2014-09 also requires disclosures sufficient to enable users to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers, including qualitative and quantitative disclosures about contracts with customers, significant judgments and changes in judgments and assets recognized from the costs to obtain or fulfill a contract. On July 9, 2015, the FASB decided to delay the effective date of this new accounting guidance by one year, which will result in it being effective for public companies for annual periods beginning after December 15, 2017. Although early adoption is permitted, the Company intends to adopt the new accounting standard effective January 1, 2018.

The two permitted transition methods under the new standard are: (1) the full retrospective method, in which case the standard would be applied to each prior reporting period presented, subject to allowable practical expedients and the cumulative effect of applying the standard would be recognized at the earliest period shown and (2) the modified retrospective method, in which case the cumulative effect of applying the standard would be recognized at the date of initial application accompanied by additional disclosures comparing the current period results presented under the new standard to the prior periods presented under the current revenue recognition standards. The Company plans to use the modified retrospective method.

The Company has substantially completed the assessment phase of the project, which has identified potential differences from the application of the new standard. Upon adoption, the Company expects that certain revenue streams currently accounted for using a point-in-time model will utilize an over-time model due to the continuous transfer of control to customers. The Company is currently designing and implementing procedures and related internal controls to address the potential differences identified, including the expanded disclosure requirements resulting from the new standard, and performing a deeper analysis of those potential differences to quantify the impacts of applying the new standard. The Company expects to finalize its evaluation of these potential differences that may result from applying the new standard to the Company's contracts with customers in 2017 and will provide updates on its progress in future filings.

Table of Contents

Note 4 - Acquisitions

During the first nine months of 2017, the Company completed three acquisitions. On July 3, 2017, the Company completed the acquisition of Groeneveld Group ("Groeneveld"), a leading provider of automatic lubrication solutions used in on- and off-highway applications. On May 5, 2017, the Company completed the acquisition of the assets of PT Tech, Inc. ("PT Tech"), a manufacturer of engineered clutches, brakes, hydraulic power take-off units and other torque management devices used in mining, aggregate, wood recycling and metals industries. On April 3, 2017, the Company completed the acquisition of Torsion Control Products, Inc. ("Torsion Control Products"), a manufacturer of engineered torsional couplings used in the construction, agriculture and mining industries. Aggregate sales for these companies for the most recent twelve months prior to their respective acquisitions totaled approximately $146.2 million. The total purchase price for these acquisitions was $346.6 million, net of $35.0 million cash received. The Company incurred acquisition-related costs of $3.6 million to complete these acquisitions. The 2017 acquisitions are subject to post-closing purchase price allocation adjustments.

results for Groeneveld, PT Tech and Torsion Control Products are reported in the Mobile Industries segment.

The following table presents the initial purchase price allocation for acquisitions in 2017:

	Initial Purchase Price Allocation
Assets:	
Accounts receivable, net	**$ 27.6**
Inventories, net	**29.1**
Other current assets	**4.7**
Property, plant and equipment, net	**31.6**
Goodwill	**147.6**
Other intangible assets	**175.3**
Other non-current assets	**1.9**
Total assets acquired	**$ 417.8**
Liabilities:	
Accounts payable, trade	**$ 9.5**
Salaries, wages and benefits	**5.8**
Other current liabilities	**8.2**
Short-term debt	**1.0**
Long-term debt	**2.0**
Deferred income taxes	**42.4**
Other non-current liabilities	**2.3**
Total liabilities assumed	**$ 71.2**
Net assets acquired	**$ 346.6**

The following table summarizes the initial purchase price allocation for identifiable intangible assets acquired in 2017:

	Initial Purchase Price Allocation

		Weighted - Average Life
Trade names (indefinite life)	$33.4	Indefinite
Trade names (finite life)	2.2	13 years
Technology and know-how	29.9	16 years
Customer relationships	108.2	17 years
Other	0.2	5 years
Capitalized software	1.4	3 years
Total intangible assets	$175.3	

10

Table of Contents

On July 5, 2017, the Company announced that the Company's majority-owned subsidiary, Timken India Ltd. ("Timken India"), entered into a definitive agreement to acquire ABC Bearings Limited ("ABC Bearings"). Timken India is a public limited company listed on the National Stock Exchange of India Limited and BSE Limited. ABC Bearings is a manufacturer of tapered, cylindrical and spherical roller bearings and slewing rings in India.

The transaction is subject to receipt of various approvals in India, which are expected to . ABC Bearings, located in Mumbai, India, operates primarily out of manufacturing facilities in Bharuch, Gujarat and Dehradun, Uttarakhand and had annual sales of approximately $29 million for the twelve months ended March 31, 2017.

During 2016, the Company completed two acquisitions. On October 31, 2016, the Company completed the acquisition of EDT Corp. ("EDT"), a manufacturer of polymer housed units and stainless steel ball bearings used primarily in the food and beverage industry. On July 8, 2016, the Company completed the acquisition of Lovejoy Inc. ("Lovejoy"), a manufacturer of premium industrial couplings and universal joints.

In January 2017, the Company paid a net purchase price adjustment of $0.6 million in connection with the EDT acquisition, resulting in an adjustment to goodwill. During the second quarter of 2017, the Company re-evaluated the fair value of certain contingent liabilities assumed in the Lovejoy acquisition, resulting in adjustments to other current assets, goodwill, other current liabilities and other non-current liabilities. The following table presents the final purchase price allocation for both the Lovejoy and the EDT acquisitions:

	Initial Purchase Price Allocation	**Adjustment**	**Final Purchase Price Allocation**
Assets:			
Accounts receivable, net	**$ 8.4**		**$ 8.4**
Inventories, net	**17.8**		**17.8**
Other current assets	**5.3**	**(0.2)**	**5.1**
Property, plant and equipment, net	**16.5**		**16.5**
Goodwill	**29.9**	**(1.1)**	**28.8**
Other intangible assets	**27.9**		**27.9**
Other non-current assets	**0.1**		**0.1**
Total assets acquired	**$ 105.9**	**$ (1.3)**	**$ 104.6**
Liabilities:			
Accounts payable, trade	**$ 8.1**		**$ 8.1**
Salaries, wages and benefits	**1.3**		**1.3**
Other current liabilities	**4.4**	**(0.6)**	**3.8**
Long-term debt	**2.2**		**2.2**
Deferred taxes	**10.4**		**10.4**
Other non-current liabilities	**7.6**	**(1.3)**	**6.3**
Total liabilities assumed	**$ 34.0**	**$ (1.9)**	**$ 32.1**
Net assets acquired	**$ 71.9**	**$ 0.6**	**$ 72.5**

Table of Contents

Note 5 - Inventories

The components of inventories at September 30, 2017 and December 31, 2016 were as follows:

	September 30, 2017	December 31, 2016
Manufacturing supplies	**$ 29.5**	$ 28.2
Raw materials	**85.7**	54.9
Work in process	**238.4**	182.9
Finished products	**367.4**	308.8
Subtotal	**$ 721.0**	$ 574.8
Allowance for obsolete and surplus inventory	**(33.5)**	(21.1)
Total Inventories, net	**$ 687.5**	$ 553.7

Inventories are valued at the lower of cost or market, with approximately 55% valued by the first-in, first-out ("FIFO") method and the remaining 45% valued by the last-in, first-out ("LIFO") method. The majority of the Company's domestic inventories are valued by the LIFO method and all of the Company's international (outside the United States) inventories are valued by the FIFO method.

An actual valuation of the inventory under the LIFO method can be made only at the end of each year based on the inventory levels and costs at that time. Accordingly, interim LIFO calculations must be based on management's estimates of expected year-end inventory levels and costs. Because these calculations are subject to many factors beyond management's control, annual results may differ from interim results as they are subject to the final year-end LIFO inventory valuation.

The LIFO reserves at September 30, 2017 and December 31, 2016 were $167.4 million and $179.5 million, respectively. The Company recognized a decrease in its LIFO reserve of $12.1 million during the first nine months of 2017, compared with a decrease in its LIFO reserve of $0.2 million during the first nine months of 2016.

Note 6 - Property, Plant and Equipment

The components of property, plant and equipment at September 30, 2017 and December 31, 2016 were as follows:

	September 30, 2017	December 31, 2016
Land and buildings	**$ 478.2**	$ 425.4
Machinery and equipment	**1,882.4**	1,807.6
Subtotal	**$ 2,360.6**	$ 2,233.0
Accumulated depreciation	**(1,518.4)**	(1,428.6)
Property, plant and equipment, net	**$ 842.2**	$ 804.4

Total depreciation expense for the nine months ended September 30, 2017 and 2016 was $73.3 million and $71.1 million, respectively.

Table of Contents

Note 7 - Goodwill and Other Intangible Assets

The changes in the carrying amount of goodwill for the nine months ended September 30, 2017 were as follows:

	Mobile Industries	Process Industries	Total
Beginning balance	**$ 97.2**	**$ 260.3**	**$357.5**
Acquisitions	**147.6**	**(1.1)**	**146.5**
Foreign currency translation adjustments	**4.0**	**2.3**	**6.3**
Ending balance	**$ 248.8**	**$ 261.5**	**$510.3**

The Groeneveld, PT Tech and Torsion Control Products acquisitions added a total of $147.6 million of goodwill to the Mobile Industries segment. The goodwill acquired from PT Tech and Torsion Control Products is expected to be tax-deductible over 15 years. The goodwill acquired from Groeneveld is not expected to be tax-deductible. The Company paid a net purchase price adjustment of $0.6 million in January 2017 in connection with the acquisition of EDT, which resulted in an increase to goodwill. The Company also adjusted its purchase price allocation for the Lovejoy acquisition in 2017, which resulted in a $1.7 million reduction to goodwill. The goodwill resulting from the EDT and Lovejoy acquisitions was allocated to the Process Industries segment.

The following table displays intangible assets as of September 30, 2017 and December 31, 2016:

	As of September 30, 2017			As of December 31, 2016		
	Gross Carrying Amount	**Accumulated Amortization**	**Net Carrying Amount**	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Intangible assets subject to amortization:						
Customer relationships	**$322.4**	**$ 97.6**	**$224.8**	$211.4	$ 84.4	$127.0
Technology and know-how	**126.4**	**29.9**	**96.5**	95.2	25.4	69.8
Trade names	**8.6**	**4.2**	**4.4**	6.5	3.8	2.7
Capitalized software	**260.0**	**223.4**	**36.6**	251.7	211.8	39.9
Other	**12.2**	**8.1**	**4.1**	11.0	7.5	3.5
	$729.6	**$ 363.2**	**$366.4**	$575.8	$ 332.9	$242.9
Intangible assets not subject to amortization:						
Trade names	**$53.8**		**$53.8**	$19.4		$19.4
FAA air agency certificates	**8.7**		**8.7**	8.7		8.7
	$62.5		**$62.5**	$28.1		$28.1
Total intangible assets	**$792.1**	**$ 363.2**	**$428.9**	$603.9	$ 332.9	$271.0

Amortization expense for intangible assets was $29.2 million and $27.2 million for the nine months ended September 30, 2017 and 2016, respectively. Amortization expense for intangible assets is estimated to be $40.5 million in 2017; $39.8 million in 2018; $36.0 million in 2019; $29.9 million in 2020; and $27.3 million in 2021.

Table of Contents

Note 8 - Financing Arrangements

Short-term debt at September 30, 2017 and December 31, 2016 was as follows:

	September 30, 2017	December 31, 2016
Variable-rate Accounts Receivable Facility with an interest rate of 2.07% at September 30, 2017	**$ 5.6**	$ —
Borrowings under variable-rate lines of credit for certain of the Company's foreign subsidiaries with various banks with interest rates ranging from 0.32% to 1.75% at September 30, 2017 and 0.50% at December 31, 2016, respectively	**35.5**	19.2
Short-term debt	**$ 41.1**	$ 19.2

The Company has a $100 million Amended and Restated Asset Securitization Agreement ("Accounts Receivable Facility") that matures on November 30, 2018. Under the terms of the Accounts Receivable Facility, the Company sells, on an ongoing basis, certain domestic trade receivables to Timken Receivables Corporation, a wholly owned consolidated subsidiary, which, in turn, uses the trade receivables to secure borrowings that are funded through a vehicle that issues commercial paper in the short-term market. Borrowings under the Accounts Receivable Facility are limited by certain borrowing base limitations. These limitations reduced the availability of the Accounts Receivable Facility to $80.3 million at September 30, 2017. As of September 30, 2017, there were outstanding borrowings of $74.8 million under the Accounts Receivable Facility, which reduced the availability under this facility to $5.5 million. The cost of this facility, which is the prevailing commercial paper rate plus program fees, is considered a financing cost and is included in interest expense in the Consolidated Statement of Income. The outstanding balance under the Accounts Receivable Facility was classified as short term or long term in accordance with the terms of the agreement and reflects the Company's expectations relative to the minimum borrowing base.

The lines of credit for certain of the Company's foreign subsidiaries provide for short-term borrowings up to $250.0 million in the aggregate. Most of these lines of credit are uncommitted. At September 30, 2017, the Company's foreign subsidiaries had borrowings outstanding of$35.5 million and bank guarantees of $2.0 million, which reduced the aggregate availability under these facilities to $212.5 million.

Long-term debt at September 30, 2017 and December 31, 2016 was as follows:

	September 30, 2017	December 31, 2016
Fixed-rate Medium-Term Notes, Series A, maturing at various dates through May 2028, with interest rates ranging from 6.74% to 7.76%	**$ 159.5**	$ 159.5
Fixed-rate Senior Unsecured Notes, maturing on September 1, 2024, with an interest rate of 3.875%	**346.6**	345.9
Variable-rate Senior Credit Facility with a weighted-average interest rate of 1.59% at September 30, 2017 and 1.50% at December 31, 2016	**91.2**	83.8
Variable-rate Accounts Receivable Facility with an interest rate of 2.07% at September 30, 2017 and 1.65% at December 31, 2016	**69.2**	48.9
Fixed-rate Euro Senior Unsecured Notes, maturing on September 7, 2027, with an interest rate of 2.02%	**176.5**	—
Variable-rate Euro Term Loan with an interest rate of 1.13% at September 30, 2017	**117.8**	—
Other	**4.0**	1.9
	$ 964.8	$ 640.0
Less: Current maturities	**5.0**	5.0
Long-term debt	**$ 959.8**	$ 635.0

The Company has a $500 million Amended and Restated Credit Agreement ("Senior Credit Facility"), which matures on June 19, 2020. At September 30, 2017, the Company had $91.2 million of outstanding borrowings under the Senior Credit Facility, which reduced the availability under this facility to $408.8 million. The Senior Credit Facility has two financial covenants: a consolidated leverage ratio and a consolidated interest coverage ratio. At September 30, 2017, the Company was in full compliance with both of these covenants.

Table of Contents

On September 7, 2017, the Company issued €150 million of fixed-rate 2.02% senior unsecured notes that mature on September 7, 2027 ("2027 Notes"). On September 18, 2017, the Company entered into a €100 million variable-rate term loan that matures on September 18, 2020 ("2020 Term Loan"). The increased borrowings were primarily to refinance the acquisition of Groeneveld that closed on July 3, 2017. Refer to *Note 4 - Acquisitions* for additional information. These debt instruments have two financial covenants: a consolidated leverage ratio and a consolidated interest coverage ratio. These covenants are the same as those in the Senior Credit Facility. At September 30, 2017, the Company was in full compliance with both of these covenants.

Note 9 - Contingencies

Product Warranties:

The Company provides limited warranties on certain of its products. The following is a rollforward of the warranty liability for the nine months ended September 30, 2017 and the twelve months ended December 31, 2016:

	September 30, 2017	December 31, 2016
Beginning balance, January 1	**$ 6.9**	$ 5.4
Additions	**2.6**	2.4
Payments	**(2.1)**	(0.9)
Ending balance	**$ 7.4**	$ 6.9

The product warranty liability at September 30, 2017 and December 31, 2016 was included in other current liabilities on the Consolidated Balance Sheets.

Currently, the Company is evaluating claims raised by certain customers with respect to the performance of bearings sold into the wind energy sector. Accruals related to this matter are included in the table above. Management believes that the outcome of these claims will not have a material effect on the Company's consolidated financial position; however, the effect of any such outcome may be material to the results of operations of any particular period in which costs in excess of amounts provided, if any, are recognized.

Note 10 - Equity

The changes in the equity components for the nine months ended September 30, 2017 were as follows:

		The Timken Company Shareholders					
	Total	Stated Capital	Other Paid-In Capital	Earnings Invested in the Business	Accumulated Other Comprehensive (Loss)	Treasury Stock	Non-controlling Interest
Balance at December 31, 2016	$1,310.9	$53.1	$906.9	$1,289.3	$ (77.9)	$(891.7)	$ 31.2
Cumulative effect of ASU 2016-09	0.5		1.4	(0.9)			
Net income	174.2			174.2			—
Foreign currency translation adjustment	42.8				40.9		1.9
Pension and postretirement liability adjustments (net of $0.1 income tax benefit)	0.2				0.2		
Change in fair value of derivative financial instruments, net of reclassifications	(4.2)				(4.2)		
Dividends paid to noncontrolling interest	(0.2)						(0.2)
Dividends – $0.80 per share	(62.4)			(62.4)			
Stock-based compensation expense	18.2		18.2				

Stock purchased at fair market value	(41.0)					(41.0)	
Stock option exercise activity	27.7		(9.7)			37.4	
Restricted share activity	—		(18.6)			18.6	
Shares surrendered for taxes	(10.8)					(10.8)	
Balance at September 30, 2017	**$1,455.9**	**$53.1**	**$898.2**	**$1,400.2**	**$(41.0)**	**$(887.5)**	**$32.9**

15

Table of Contents

Note 11 - Accumulated Other Comprehensive Income (Loss)

The following tables present details about components of accumulated other comprehensive loss for the three and nine months ended September 30, 2017 and 2016, respectively:

	Foreign currency translation adjustments	Pension and postretirement liability adjustments	Change in fair value of derivative financial instruments	Total
Balance at June 30, 2017	$ (49.9)	$ 1.6	$ (1.8)	$ (50.1)
Other comprehensive income (loss) before reclassifications and income tax	10.9	—	(4.0)	6.9
Amounts reclassified from accumulated other comprehensive income, before income tax	—	0.1	0.9	1.0
Income tax expense	—	—	1.1	1.1
Net current period other comprehensive income (loss), net of income taxes	10.9	0.1	(2.0)	9.0
Noncontrolling interest	0.1	—	—	0.1
Net current period comprehensive income (loss), net of income taxes and noncontrolling interest	11.0	0.1	(2.0)	9.1
Balance at September 30, 2017	**$ (38.9)**	**$ 1.7**	**$ (3.8)**	**$ (41.0)**

	Foreign currency translation adjustments	Pension and postretirement liability adjustments	Change in fair value of derivative financial instruments	Total
Balance at December 31, 2016	$ (79.8)	$ 1.5	$ 0.4	$ (77.9)
Other comprehensive income (loss) before reclassifications and income tax	42.8	—	(7.1)	35.7
Amounts reclassified from accumulated other comprehensive income, before income tax	—	0.3	0.4	0.7
Income tax expense (benefit)	—	(0.1)	2.5	2.4
Net current period other comprehensive income (loss), net of income taxes	42.8	0.2	(4.2)	38.8
Noncontrolling interest	(1.9)	—	—	(1.9)
Net current period comprehensive income (loss), net of income taxes and noncontrolling interest	40.9	0.2	(4.2)	36.9
Balance at September 30, 2017	**$ (38.9)**	**$ 1.7**	**$ (3.8)**	**$ (41.0)**

Table of Contents

	Foreign currency translation adjustments	Pension and postretirement liability adjustments	Change in fair value of derivative financial instruments	Total
Balance at June 30, 2016	$ (55.1)	$ 1.2	$ (1.3)	$ (55.2)
Other comprehensive income (loss) before reclassifications and income tax	3.7	—	(0.5)	3.2
Amounts reclassified from accumulated other comprehensive income, before income tax	—	0.7	0.5	1.2
Income tax benefit	—	(0.3)	—	(0.3)
Net current period other comprehensive income, net of income taxes	3.7	0.4	—	4.1
Noncontrolling interest	(0.6)	—	—	(0.6)
Net current period comprehensive income, net of income taxes and noncontrolling interest	3.1	0.4	—	3.5
Balance at September 30, 2016	$ (52.0)	$ 1.6	$ (1.3)	$ (51.7)

	Foreign currency translation adjustments	Pension and postretirement liability adjustments	Change in fair value of derivative financial instruments	Total
Balance at December 31, 2015	$ (55.3)	$ 0.4	$ 0.3	$ (54.6)
Other comprehensive income (loss) before reclassifications and income tax	5.2	—	(2.5)	2.7
Amounts reclassified from accumulated other comprehensive income (loss), before income tax	—	2.0	(0.1)	1.9
Income tax (benefit) expense	—	(0.8)	1.0	0.2
Net current period other comprehensive income (loss), net of income taxes	5.2	1.2	(1.6)	4.8
Noncontrolling interest	(1.9)	—	—	(1.9)
Net current period comprehensive income (loss), net of income taxes and noncontrolling interest	3.3	1.2	(1.6)	2.9
Balance at September 30, 2016	$ (52.0)	$ 1.6	$ (1.3)	$ (51.7)

Other comprehensive income (loss) before reclassifications and income taxes includes the effect of foreign currency.

The before-tax reclassification of pension and postretirement liability adjustments was due to the amortization of prior service costs and was included in costs of products sold and SG&A expenses in the Consolidated Statement of Income. The reclassification of the remaining components of accumulated other comprehensive loss was included in "Other income (expense), net" in the Consolidated Statement of Income.

Table of Contents

Note 12 - Earnings Per Share

The following table sets forth the reconciliation of the numerator and the denominator of basic earnings per share and diluted earnings per share for the three and nine months ended September 30, 2017 and 2016, respectively:

	Three Months Ended September 30, **2017**	2016	Nine Months Ended September 30, **2017**	2016
Numerator:				
Net income attributable to The Timken Company	**$53.5**	$ 33.6	**$174.2**	$ 147.7
Less: undistributed earnings allocated to nonvested stock	**—**	—	**—**	—
Net income available to common shareholders for basic earnings per share and diluted earnings per share	**$53.5**	$ 33.6	**$174.2**	$ 147.7
Denominator:				
Weighted average number of shares outstanding, basic	**77,694,974**	76,985,783	**77,766,828**	76,808,179
Effect of dilutive securities:				
Stock options and awards based on the treasury stock method	**1,109,322**	631,693	**1,123,102**	663,577
Weighted average number of shares outstanding, assuming dilution of stock options and awards	**78,804,296**	77,617,476	**78,889,930**	77,471,756
Basic earnings per share	**$0.69**	$ 0.43	**$2.24**	$ 1.87
Diluted earnings per share	**$0.68**	$ 0.43	**$2.21**	$ 1.86

The exercise prices for certain stock options that the Company has awarded exceed the average market price of the Company's common shares. Such stock options are antidilutive and were not included in the computation of diluted earnings per share. The antidilutive stock options outstanding during the three months ended September 30, 2017 and 2016 were 473,694 and 2,706,711, respectively. During the nine months ended September 30, 2017 and 2016, the antidilutive stock options outstanding were 529,020 and 3,080,133, respectively.

Note 13 - Segment Information

The primary measurement used by management to measure the financial performance of each segment is earnings before interest and taxes ("EBIT").

	Three Months Ended September 30, **2017**	2016	Nine Months Ended September 30, **2017**	2016
Net sales:				
Mobile Industries	**$422.8**	$353.1	**$1,214.2**	$1,104.1
Process Industries	**348.6**	304.3	**1,011.6**	910.9
	$771.4	$657.4	**$2,225.8**	$2,015.0
Segment EBIT:				
Mobile Industries	**$34.9**	$25.9	**$100.1**	$95.3
Process Industries	**61.7**	42.0	**164.9**	123.7
Total EBIT, for reportable segments	**$96.6**	$67.9	**$265.0**	$219.0
Corporate expenses	**(12.0)**	(10.9)	**(37.8)**	(34.8)
Continued Dumping & Subsidy Offset Act income (expense), net	**—**	(0.2)	**—**	53.6

Interest expense	**(10.1)**	(8.0)	**(26.5)**	(25.1)
Interest income	**0.7**	0.4	**2.0**	1.1
Income before income taxes	**$75.2**	$49.2	**$202.7**	$213.8

18

Table of Contents

Note 14 - Impairment and Restructuring Charges

Impairment and restructuring charges by segment are comprised of the following:

For the three months ended September 30, 2017:

	Mobile Industries	**Process Industries**	**Corporate**	**Total**
Severance and related benefit costs	**$ 1.3**	**$ —**	**$ —**	**$ 1.3**
Total	**$ 1.3**	**$ —**	**$ —**	**$ 1.3**

For the three months ended September 30, 2016:

	Mobile Industries	Process Industries	Corporate	Total
Impairment charges	$ 1.2	$ —	$ —	$ 1.2
Severance and related benefit costs	2.9	0.4	—	3.3
Exit costs	0.3	0.5	—	0.8
Total	$ 4.4	$ 0.9	$ —	$ 5.3

For the nine months ended September 30, 2017:

	Mobile Industries	**Process Industries**	**Corporate**	**Total**
Severance and related benefit costs	**$ 3.1**	**$ 0.1**	**$ —**	**$ 3.2**
Exit costs	**0.1**	**—**	**0.5**	**0.6**
Total	**$ 3.2**	**$ 0.1**	**$ 0.5**	**$ 3.8**

For the nine months ended September 30, 2016:

	Mobile Industries	Process Industries	Corporate	Total
Impairment charges	$ 3.8	$ —	$ —	$ 3.8
Severance and related benefit costs	7.7	4.9	—	12.6
Exit costs	1.6	0.7	—	2.3
Total	$ 13.1	$ 5.6	$ —	$ 18.7

The following discussion explains the impairment and restructuring charges recorded for the periods presented; however, it is not intended to reflect a comprehensive discussion of all amounts in the tables above.

On September 29, 2016, the Company announced the closure of its bearing plant in Pulaski, Tennessee ("Pulaski"), which is expected to close during the fourth quarter of 2017 and to affect approximately 120 employees. During the three and nine months ended September 30, 2017, the Company recognized severance and related benefit costs of $0.2 million and $1.3 million, respectively, related to this closure. During the three months ended September 30, 2016, the Company recorded severance and related benefit costs of $1.7 million related to this closure. The Company has incurred pretax costs related to this closure of $8.1 million as of September 30, 2017, including rationalization costs recorded in cost of products sold.

In August 2016, the Company completed the consultation process to close the manufacturing operations in Benoni, South Africa ("Benoni") affecting 85 employees. Benoni will continue to recondition bearings and assemble rail bearings. During the three months ended September 30, 2016, the Company recorded impairment charges of $0.5 million and severance and related benefit costs of $0.8 million related to this closure.

Table of Contents

On March 17, 2016, the Company announced the closure of its bearing plant in Altavista, Virginia ("Altavista"). The Company completed the closure of this manufacturing facility on March 31, 2017. During the three months ended September 30, 2016, the Company recorded impairment charges of $0.7 million and severance and related benefit costs of $0.2 million related to this closure. During the nine months ended September 30, 2016, the Company recorded impairment charges of $3.1 million and severance and related benefit costs of $1.7 million in connection with this closure. The Company has incurred pretax costs related to this closure of $11.5 million as of September 30, 2017, including rationalization costs recorded in cost of products sold.

During the three months and nine months ended September 30, 2017, the Company recognized $0.7 million and $1.5 million, respectively, of severance and related benefit costs to eliminate approximately 50 positions in the aggregate. The amounts recognized for the three months and nine months ended September 30, 2017 primarily related to the Mobile Industries segment. During the nine months ended September 30, 2016, the Company recognized $7.7 million of severance and related benefit costs to eliminate approximately 175 positions. Of the $7.7 million charge for the first nine months of 2016, $2.9 million related to the Mobile Industries segment and $4.8 million related to the Process Industries segment.

Consolidated Restructuring Accrual:

The following is a rollforward of the consolidated restructuring accrual for the nine months ended September 30, 2017 and the twelve months ended December 31, 2016:

	September 30, 2017	December 31, 2016
Beginning balance, January 1	**$ 10.1**	$ 11.3
Expense	**3.8**	17.8
Payments	**(9.2)**	(19.0)
Ending balance	**$ 4.7**	$ 10.1

The restructuring accruals at September 30, 2017 and December 31, 2016 were included in other current liabilities on the Consolidated Balance Sheets.

Table of Contents

Note 15 - Retirement Benefit Plans

The following table sets forth the net periodic benefit cost for the Company’s defined benefit pension plans. The amounts for the three and nine months ended September 30, 2017 are based on calculations prepared by the Company's actuaries and represent the Company’s best estimate of each period’s proportionate share of the amounts to be recorded for the year ending December 31, 2017.

	U.S. Plans		**International Plans**		**Total**	
	Three Months Ended September 30,		**Three Months Ended September 30,**		**Three Months Ended September 30,**	
	2017	2016	**2017**	2016	**2017**	2016
Components of net periodic benefit cost:						
Service cost	**$3.1**	$3.3	**$0.4**	$0.4	**$3.5**	$3.7
Interest cost	**6.2**	6.6	**1.9**	2.6	**8.1**	9.2
Expected return on plan assets	**(7.0)**	(7.4)	**(2.9)**	(2.6)	**(9.9)**	(10.0)
Amortization of prior service cost	**0.3**	0.4	**0.1**	0.1	**0.4**	0.5
Net periodic benefit cost	**$2.6**	$2.9	**$(0.5)**	$0.5	**$2.1**	$3.4

	U.S. Plans		**International Plans**		**Total**	
	Nine Months Ended September 30,		**Nine Months Ended September 30,**		**Nine Months Ended September 30,**	
	2017	2016	**2017**	2016	**2017**	2016
Components of net periodic benefit cost:						
Service cost	**$9.2**	$9.9	**$1.2**	$1.1	**$10.4**	$11.0
Interest cost	**18.5**	20.0	**5.6**	8.2	**24.1**	28.2
Expected return on plan assets	**(21.0)**	(22.3)	**(8.3)**	(8.0)	**(29.3)**	(30.3)
Amortization of prior service cost	**1.0**	1.2	**0.1**	0.1	**1.1**	1.3
Recognition of actuarial loss	**4.4**	—	**—**	—	**4.4**	—
Net periodic benefit cost	**$12.1**	$8.8	**$(1.4)**	$1.4	**$10.7**	$10.2

During the first three months of 2017, the Company recognized actuarial losses of $4.4 million as a result of the remeasurement of plan assets and obligations for one of the Company’s United States ("U.S.") defined benefit pension plans. The remeasurement was due to lump sum payments exceeding service and interest costs for this plan.

Note 16 - Other Postretirement Benefit Plans

The following table sets forth the net periodic benefit cost for the Company’s other postretirement benefit plans. The amounts for the three and nine months ended September 30, 2017 are based on calculations prepared by the Company's actuaries and represent the Company’s best estimate of each period’s proportionate share of the amounts to be recorded for the year ending December 31, 2017.

	Three Months Ended September	**Nine Months Ended September**

	30, 2017	2016	30, 2017	2016
Components of net periodic benefit cost:				
Service cost	**$—**	$0.1	**$0.1**	$0.3
Interest cost	**2.3**	2.7	**6.8**	8.2
Expected return on plan assets	**(1.4)**	(1.6)	**(4.2)**	(4.9)
Amortization of prior service cost	**(0.3)**	0.2	**(0.8)**	0.7
Net periodic benefit cost	**$0.6**	$1.4	**$1.9**	$4.3

21

Table of Contents

Note 17 - Income Taxes

The Company's provision for income taxes in interim periods is computed by applying the estimated annual effective tax rates to income or loss before income taxes for the period. In addition, non-recurring or discrete items are recorded during the period(s) in which they occur.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	**2017**	2016
Provision for income taxes	**$21.1**	$15.2	**$28.5**	$65.8
Effective tax rate	**28.1 %**	30.9 %	**14.1 %**	30.8 %

The income tax expense for the third quarter and first nine months of 2017 was calculated using the forecasted multi-jurisdictional annual effective tax rates to determine a blended annual effective tax rate. The effective tax rate differs from the U.S. federal statutory rate of 35% primarily due to the projected mix of earnings in international jurisdictions with relatively lower tax rates and tax benefits related to foreign tax credits, which are partially offset by losses in jurisdictions with no tax benefit due to valuation allowances.

Income tax expense increased for the third quarter of 2017 compared to the third quarter of 2016 primarily due to the significant increase in pre-tax earnings, primarily in non-U.S. jurisdictions. The expense was partially offset by favorable U.S. tax deductions, tax credits and favorable discrete tax amounts.

Income tax expense for the nine months ended September 30, 2017 is lower than the nine months ended September 30, 2016 primarily due to the net reversal of accruals for prior year uncertain tax positions recorded discretely and favorable U.S. tax deductions and tax credits.

The following table is a rollforward of the Company's gross unrecognized tax benefits for the nine months ended September 30, 2017:

	September 30, 2017
Beginning balance, January 1	**$ 39.1**
Tax positions related to the prior years:	
Additions	**5.6**
Reductions	**(1.3)**
Lapses in statutes of limitation	**(28.6)**
Ending Balance	**$ 14.8**

Table of Contents

Note 18 - Fair Value

Fair value is defined as the price that would be expected to be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (exit price). The FASB provides accounting rules that classify the inputs used to measure fair value into the following hierarchy:

Level 1 – Unadjusted quoted prices in active markets for identical assets or liabilities.

Level 2 – Unadjusted quoted prices in active markets for similar assets or liabilities, or unadjusted quoted prices for identical or similar assets or liabilities in markets that are not active, or inputs other than quoted prices that are observable for the asset or liability.

Level 3 – Unobservable inputs for the asset or liability.

The following tables present the fair value hierarchy for those financial assets and liabilities measured at fair value on a recurring basis as of September 30, 2017 and December 31, 2016:

	September 30, 2017			
	Total	Level 1	Level 2	Level 3
Assets:				
Cash and cash equivalents	**$125.4**	**$120.5**	**$ 4.9**	**$ —**
Cash and cash equivalents measured at net asset value	**11.8**	—	**—**	**—**
Restricted cash	**3.3**	**3.3**	**—**	**—**
Short-term investments	**16.5**	**—**	**16.5**	**—**
Short-term investments measured at net asset value	**0.2**	**—**	**—**	**—**
Foreign currency hedges	**1.6**	**—**	**1.6**	**—**
Total Assets	**$158.8**	**$123.8**	**$ 23.0**	**$ —**
Liabilities:				
Foreign currency hedges	**$3.9**	**$—**	**$ 3.9**	**$ —**
Total Liabilities	**$3.9**	**$—**	**$ 3.9**	**$ —**

	December 31, 2016			
	Total	Level 1	Level 2	Level 3
Assets:				
Cash and cash equivalents	$129.6	$125.0	$ 4.6	$ —
Cash and cash equivalents measured net asset value	19.2	—	—	—
Restricted cash	2.7	2.7	—	—
Short-term investments	9.4	—	9.4	—
Short-term investments measured at net asset value	2.3	—	—	—
Foreign currency hedges	9.9	—	9.9	—
Total Assets	$173.1	$127.7	$ 23.9	$ —
Liabilities:				
Foreign currency hedges	$2.1	$—	$ 2.1	$ —
Total Liabilities	$2.1	$—	$ 2.1	$ —

Cash and cash equivalents are highly liquid investments with maturities of three months or less when purchased and are valued at the redemption value. Short-term investments are investments with maturities between four months and one year and generally are valued at amortized cost, which approximates fair value. A portion of the cash and cash equivalents and short-term investments are valued based on net asset value. The Company uses publicly available foreign currency forward and spot rates to measure the fair value of its foreign currency forward contracts.

Table of Contents

The Company does not believe it has significant concentrations of risk associated with the counterparties to its financial instruments.

2017
No assets were measured at fair value on a nonrecurring basis for the nine months ended September 30, 2017.

2016
The following table presents those assets measured at fair value on a nonrecurring basis for the nine months ended September 30, 2016 using Level 3 inputs:

	Carrying Value	Fair Value Adjustment	Fair Value
Long-lived assets held for sale:			
Land	$ 0.2	$ (0.2)	$ —
Total long-lived assets held for sale	$ 0.2	$ (0.2)	$ —
Long-lived assets held and used:			
Altavista bearing plant	$ 5.6	$ (3.1)	$ 2.5
Equipment at Benoni bearing plant	0.5	(0.5)	—
Total long-lived assets held and used	$ 6.1	$ (3.6)	$ 2.5

Assets held for sale of $0.2 million were written down to their fair value of zero during the first quarter of 2016, resulting in an impairment charge of $0.2 million. The fair value of these assets was based on the price that the Company expected to receive when it disposed of these assets.

On March 17, 2016, the Company announced the closure of its Altavista bearing plant. The Company completed the closure of this manufacturing facility on March 31, 2017. The Altavista bearing plant, with a carrying value of $5.6 million, was written down to its fair value of $3.2 million during the first quarter of 2016, resulting in an impairment charge of $2.4 million. The fair value for the plant was based on the price that the Company expected to receive from the sale of this facility. During the third quarter of 2016, the Company reevaluated the fair value of this facility. The Altavista bearing plant was written down to its fair value of $2.5 million during the third quarter of 2016, resulting in an additional impairment of $0.7 million. During the second quarter of 2017, this facility was reclassified to assets held for sale and included in other current assets on the Consolidated Balance Sheet. On July 14, 2017, this facility was sold for a pretax gain of approximately $1.6 million.

In August 2016, the Company completed the consultation process to close the manufacturing operations in Benoni. The Benoni facility will continue to recondition bearings and assemble rail bearings. Equipment at this facility, with a carrying value of $0.5 million, was written down to its fair value of zero during the third quarter of 2016, resulting in an impairment charge of $0.5 million. The fair value for the equipment was based on the price that the Company expected to receive from the sale of the equipment.

Financial Instruments:
The Company’s financial instruments consist primarily of cash and cash equivalents, restricted cash, short-term investments, accounts receivable net, accounts payable, trade, short-term borrowings and long-term debt. Due to their short-term nature, the carrying value of cash and cash equivalents, restricted cash, short-term investments, accounts receivable net, accounts payable, trade and short-term borrowings are a reasonable estimate of their fair value. Due to the nature of fair value calculations for variable-rate debt, the carrying value of the Company's long-term variable rate debt is a reasonable estimate of its fair

value. The fair value of the Company's long-term fixed-rate debt, based on quoted market prices, was $723.9 million and $532.2 million at September 30, 2017 and December 31, 2016, respectively. The carrying value of this debt was $684.3 million and $507.3 million at September 30, 2017 and December 31, 2016, respectively. The fair value of long-term fixed-rate debt was measured using Level 2 inputs.

Table of Contents

Note 19 - Derivative Instruments and Hedging Activities

The Company is exposed to certain risks relating to its ongoing business operations. The primary risks managed by using derivative instruments are foreign currency exchange rate risk, commodity price risk and interest rate risk. Forward exchange contracts on various foreign currencies are entered into in order to manage the foreign currency exchange rate risk associated with certain of the Company's commitments denominated in foreign currencies.

The Company designates certain foreign currency forward contracts as cash flow hedges of forecasted revenues and expenses and certain interest rate hedges as fair value hedges of fixed-rate borrowings.

The Company does not purchase or hold any derivative financial instruments for trading purposes. As of September 30, 2017 and December 31, 2016, the Company had $223.2 million and $282.8 million, respectively, of outstanding foreign currency forward contracts at notional value. Refer to *Note 18 - Fair Value* for the fair value disclosure of derivative financial instruments.

Cash Flow Hedging Strategy:

For certain derivative instruments that are designated and qualify as cash flow hedges (*i.e.*, hedging the exposure to variability in expected future cash flows that is attributable to a particular risk), the effective portion of the gain or loss on the derivative instrument is reported as a component of other comprehensive income and reclassified into earnings in the same line item associated with the forecasted transaction and in the same period or periods during which the hedged transaction affects earnings. The remaining gain or loss on the derivative instrument in excess of the cumulative change in the present value of future cash flows of the hedged item, if any (*i.e.*, the ineffective portion), or hedge components excluded from the assessment of effectiveness, are recognized in the Consolidated Statement of Income during the current period.

To protect against a reduction in the value of forecasted foreign currency cash flows resulting from export sales over the next year, the Company has instituted a foreign currency cash flow hedging program. The Company hedges portions of its forecasted revenue or expense denominated in foreign currencies with forward contracts. When the dollar strengthens significantly against foreign currencies, the decline in the present value of future foreign currency revenue is offset by gains in the fair value of the forward contracts designated as hedges. Conversely, when the dollar weakens, the increase in the present value of future foreign currency cash flows is offset by losses in the fair value of the forward contracts.

The length of time over which the Company hedges its exposure to the variability in future cash flows for forecasted transactions is generally 18 months or less.

Fair Value Hedging Strategy:

For derivative instruments that are designated and qualify as fair value hedges (*i.e.*, hedging the exposure to changes in the fair value of an asset or a liability or an identified portion thereof that is attributable to a particular risk), the gain or loss on the derivative instrument as well as the offsetting loss or gain on the hedged item attributable to the hedged risk are recognized in the same line item associated with the hedged item (*i.e.*, in interest expense when the hedged item is fixed-rate debt).

Purpose for Derivative Instruments not Designated as Hedging Instruments:

For derivative instruments that are not designated as hedging instruments, the instruments typically are forward contracts. In general, the practice is to reduce volatility by selectively hedging transaction exposures including intercompany loans, accounts payable and accounts receivable. Intercompany loans between entities with different functional currencies typically are hedged with a forward contract at the inception of the loan with a maturity date at the maturity of the loan. The revaluation of these contracts, as well as the underlying balance sheet items, is recorded directly to the income statement so the adjustment generally offsets the revaluation of the underlying balance sheet items to protect cash payments and reduce income statement volatility.

Table of Contents

The following table presents the fair value of the Company's derivative instruments. Those balances are presented in the other non-current assets/liabilities accounts within the Consolidated Balance Sheets.

	Derivative Assets		Derivatives Liabilities	
Derivatives designated as hedging instruments	**Fair Value at 9/30/17**	Fair Value at 12/31/16	**Fair Value at 9/30/17**	Fair Value at 12/31/16
Foreign currency forward contracts	**$ 0.3**	$ 2.3	**$ 2.9**	$ 0.5
Derivatives not designated as hedging instruments				
Foreign currency forward contracts	**1.3**	7.6	**1.0**	1.6
Total Derivatives	**$ 1.6**	$ 9.9	**$ 3.9**	$ 2.1

The following tables present the impact of derivative instruments and their location within the Consolidated Statements of Income:

	Amount of gain or (loss) recognized in Other Comprehensive Income on derivative instruments			
	Three Months Ended September 30,		Nine Months Ended September 30,	
Derivatives in cash flow hedging relationships	**2017**	2016	**2017**	2016
Foreign currency forward contracts	**$(1.6)**	$(0.5)	**$(4.7)**	$(2.5)
Interest rate swaps	**(2.4)**	—	**(2.4)**	—
Total	**$(4.0)**	$(0.5)	**$(7.1)**	$(2.5)

	Amount of gain or (loss) reclassified from Accumulated Other Comprehensive Loss into income (effective portion)			
	Three Months Ended September 30,		Nine Months Ended September 30,	
Derivatives in cash flow hedging relationships	**2017**	2016	**2017**	2016
Foreign currency forward contracts	**$(0.9)**	$(0.4)	**$(0.2)**	$0.4
Interest rate swaps	**—**	(0.1)	**(0.2)**	(0.3)
Total	**$(0.9)**	$(0.5)	**$(0.4)**	$0.1

		Amount of gain or (loss) recognized in income on derivative instruments			
		Three Months Ended September 30,		Nine Months Ended September 30,	
Derivatives not designated as hedging instruments	**Location of gain or (loss) recognized in income on derivative**	**2017**	2016	**2017**	2016
Foreign currency forward contracts	Other income (expense), net	**$2.7**	$(0.2)	**$(5.6)**	$(4.5)

26

Table of Contents

Note 20 - Continued Dumping and Subsidy Offset Act

The U.S. Continued Dumping and Subsidy Offset Act ("CDSOA") provides for distribution of monies collected by U.S. Customs and Border Protection ("U.S. Customs") on entries of merchandise subject to antidumping orders that entered the U.S. prior to October 1, 2007 to qualifying domestic producers where the domestic producers have continued to invest in their technology, equipment and people. During the third quarter of 2016, the Company recognized CDSOA expense of $0.2 million. During the first nine months of 2016, the Company recognized pretax CDSOA income, net of related expenses, of $53.6 million.

In September 2002, the World Trade Organization ruled that CDSOA payments are not consistent with international trade rules. In February 2006, U.S. legislation was enacted that ended CDSOA distributions for imports covered by antidumping duty orders entering the U.S. after September 30, 2007. Instead, any such antidumping duties collected would remain with the U.S. Treasury.

CDSOA has been the subject of significant litigation since 2002 and U.S. Customs has withheld CDSOA distributions for certain years while litigation was ongoing. However, much of the CDSOA litigation that involves antidumping orders where Timken is a qualifying domestic producer has concluded.

Subsequently, the Company was notified by letters dated March 25, 2016 and June 24, 2016 that funds were being distributed to the Company. On April 1, 2016 and July 1, 2016, the Company received CDSOA distributions of $48.1 million and $6.3 million, respectively, representing funds that would have been distributed to the Company at the end of calendar years 2011 through 2015.

While some of the challenges to CDSOA have been resolved, others are still in litigation. Since there continue to be legal challenges to CDSOA, U.S. Customs has advised all affected domestic producers that it is possible that CDSOA distributions could be subject to clawback. Management of the Company believes that the likelihood of any clawback is remote.

Table of Contents

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS
(Dollars in millions, except per share data)

Overview
Introduction:

The Timken Company engineers, manufactures and markets bearings, transmissions, gearboxes, belts, chain, lubrication systems, couplings, industrial clutches and brakes and related products and offers a variety of power system rebuild and repair services. The Company's growing product and services portfolio features many strong industrial brands, such as Timken®, Fafnir®, Philadelphia Gear®, Drives®, Lovejoy® and Groeneveld®. Timken applies its deep knowledge of metallurgy, friction management and mechanical power transmission across the broad spectrum of bearings and related systems to improve the reliability and efficiency of machinery and equipment all around the world. Known for its quality products and collaborative technical sales model, Timken focuses on providing value to diverse markets worldwide through both original equipment manufacturers ("OEMs") and aftermarket channels. With more than 14,000 people operating in 31 countries, Timken makes the world more productive and keeps industry in motion. The Company operates under two reportable segments: (1) Mobile Industries and (2) Process Industries. The following further describes these business segments:

- **Mobile Industries** serves OEM customers that manufacture off-highway equipment for the agricultural, mining and construction markets; on-highway vehicles including passenger cars, light trucks and medium- and heavy-duty trucks; rail cars and locomotives; outdoor power equipment; and rotorcraft and fixed-wing aircraft. Beyond service parts sold to OEMs, aftermarket sales to individual end users, equipment owners, operators and maintenance shops are handled through the Company's extensive network of authorized automotive and heavy-truck distributors.

- **Process Industries** serves OEM and end-user customers in industries that place heavy demands on the fixed operating equipment they make or use in heavy and other general industrial sectors. This includes metals, cement and aggregate production; coal and wind power generation; oil and gas extraction and refining; pulp and paper and food processing; and health and critical motion control equipment. Other applications include marine equipment, gear drives, cranes, hoists and conveyors. This segment also supports aftermarket sales and service needs through its global network of authorized industrial distributors.

Timken creates value by understanding customer needs and applying its know-how in attractive market sectors. The Company's business strengths include its channel mix and end-market diversity, serving a broad range of customers and industries across the globe. Timken collaborates with OEMs to improve equipment efficiency with its engineered products and captures subsequent equipment replacement cycles by selling through independent channels in the aftermarket. Timken focuses its international efforts and footprint in regions of the world where strong macroeconomic factors such as urbanization, infrastructure development and sustainability create demand for its products and services.

The **Timken Business Model** is the specific framework for how the Company evaluates opportunities and differentiates itself in the market.
The Company's Strategy is to apply the**Timken Business Model** and leverage the Company's competitive differentiators and strengths to create customer value and drive increased growth and profitability by:

Outgrowing Our Markets. The Company intends to expand into new and existing markets by leveraging its collective knowledge of metallurgy, friction management and mechanical power transmission to create value for Timken customers. Using a highly collaborative technical selling approach, the Company places particular emphasis on creating unique solutions for challenging and/or demanding applications. The Company intends to grow in attractive market sectors around the world, emphasizing those spaces that are highly fragmented, demand high service and value the reliability and efficiency offered by Timken products. The Company also targets those applications that offer significant aftermarket demand, thereby providing product and services revenue throughout the equipment's lifetime.

Operating With Excellence. Timken operates with a relentless drive for exceptional results and a passion for superior execution. The Company embraces a continuous improvement culture that is charged with increasing efficiency, lowering costs, eliminating waste, encouraging organizational agility and building greater brand equity to fuel future growth. This requires the Company's ongoing commitment to attract, retain and develop the best talent across the world.

Deploying Capital to Drive Shareholder Value. The Company is intently focused on providing the highest returns for shareholders through its capital allocation framework, which includes: (1) investing in the core business through capital expenditures, research and development and organic growth initiatives; (2) pursuing strategic acquisitions to broaden our portfolio and capabilities, with a focus on bearings, adjacent power transmission products and related services; and (3) returning capital to shareholders through share repurchases and dividends. As part of this framework, the Company also may restructure, reposition or divest underperforming product lines or assets.

Table of Contents

The following highlights the Company's recent significant strategic accomplishments:

Table of Contents

Overview:

	Three Months Ended September 30,			
	2017	2016	$ Change	% Change
Net sales	**$771.4**	$ 657.4	$ 114.0	17.3 %
Net income	**54.1**	34.0	20.1	59.1 %
Net income attributable to noncontrolling interest	**0.6**	0.4	0.2	50.0 %
Net income attributable to The Timken Company	**53.5**	33.6	19.9	59.2 %
Diluted earnings per share	**$0.68**	$ 0.43	$ 0.25	58.1 %
Average number of shares – diluted	**78,804,296**	78,617,476	—	0.2 %

	Nine Months Ended September 30,			
	2017	2016	$ Change	% Change
Net sales	**$2,225.8**	$ 2,015.0	$ 210.8	10.5 %
Net income	**174.2**	148.0	26.2	17.7 %
Net income attributable to noncontrolling interest	**—**	0.3	(0.3)	(100.0)%
Net income attributable to The Timken Company	**174.2**	147.7	26.5	17.9 %
Diluted earnings per share	**$2.21**	$ 1.86	$ 0.35	18.8 %
Average number of shares – diluted	**78,889,930**	79,471,756	—	(0.7)%

The increase in net sales for the third quarter of 2017 compared with the third quarter of 2016 was primarily due to higher demand across most end markets and the benefit of acquisitions. The increase in net income for the third quarter of 2017 compared with the third quarter of 2016 was primarily due to the impact of higher volume, the benefit of acquisitions, favorable manufacturing performance, the favorable impact of foreign currency exchange rate changes and lower impairment and restructuring charges. These factors were partially offset by higher SG&A expense and unfavorable price/mix.

The increase in net sales for the first nine months of 2017 compared with the first nine months of 2016 was primarily due to higher end-market demand and the net benefit of acquisitions. The change in net income for the first nine months of 2017 compared with the first nine months of 2016 was primarily due to the impact of higher volume, lower income tax expense as a result of the net reversal of accruals for uncertain tax positions related to prior years, the benefit of acquisitions, lower restructuring charges, the favorable impact of foreign currency exchange rate changes and favorable manufacturing performance. These factors were partially offset by pre-tax CDSOA income of $53.6 million recognized in 2016 that did not reoccur in 2017, unfavorable price/mix, higher SG&A expense and a pension mark-to-market remeasurement charge recorded during the first quarter of 2017.

Outlook:

The Company expects 2017 full-year net sales to increase approximately 12% compared with 2016 primarily driven by higher demand in the industrial distribution, off-highway, heavy industries and heavy truck sectors and the benefit of acquisitions, partially offset by lower demand in the rail sector. The Company's earnings are expected to be higher in 2017 compared with 2016, primarily due to the impact of higher volume, favorable manufacturing performance, lower restructuring charges, lower income tax expense and the benefit of acquisitions. These factors are expected to be partially offset by unfavorable price/mix, higher material and logistics costs, increased SG&A expense and the expected absence of CDSOA income in 2017. The results for 2016 include the impacts of pension and other postretirement benefit mark-to-market remeasurement charges, which are not accounted for in the 2017 outlook because the amount will not be known until the fourth quarter.

The Company expects to generate operating cash of approximately $280 million in 2017, a decrease from 2016 of approximately $124 million or 31%, driven by the absence of CDSOA receipts, higher tax payments and unfavorable working capital, partially offset by higher operating income. The Company expects capital expenditures to be between 3% and 3.5% of net sales in 2017, compared with 5% of net sales in 2016.

Table of Contents

The Statement of Income

Sales:

	Three Months Ended September 30, 2017	2016	$ Change	% Change
Net Sales	**$771.4**	$657.4	$ 114.0	17.3 %

	Nine Months Ended September 30, 2017	2016	$ Change	% Change
Net Sales	**$2,225.8**	$2,015.0	$ 210.8	10.5 %

Net sales increased for the third quarter of 2017 compared with the third quarter of 2016, primarily due to higher organic revenue of $61 million, the benefit of acquisitions of $44 million and the favorable impact of foreign currency exchange rate changes. The increase in organic sales volume was driven by higher demand across most of the Company's market sectors led by industrial distribution and off-highway, partially offset by lower demand in the automotive market sector.

Net sales increased for the first nine months of 2017 compared with the first nine months of 2016, primarily due to higher organic revenue of $121 million and the benefit of acquisitions of $86 million. The increase in organic sales volume was driven by higher demand across most of the Company's market sectors led by industrial distribution and off-highway, partially offset by lower demand in the rail and automotive market sectors.

Gross Profit:

	Three Months Ended September 30, 2017	2016	$ Change	Change
Gross profit	**$217.0**	$169.7	$ 47.3	27.9%
Gross profit % to net sales	**28.1 %**	25.8 %	—	230 bps

	Nine Months Ended September 30, 2017	2016	$ Change	Change
Gross profit	**$599.3**	$537.3	$ 62.0	11.5%
Gross profit % to net sales	**26.9 %**	26.7 %		20 bps

Gross profit increased in the third quarter of 2017 compared with the third quarter of 2016, primarily due to the impact of higher sales volume of $23 million, the benefit of acquisitions of $18 million, favorable manufacturing performance of $14 million and the favorable impact of foreign currency exchange rate changes. These factors were partially offset by higher material and logistics costs of $9 million and unfavorable price/mix.

Gross profit increased in the first nine months of 2017 compared with the first nine months of 2016, primarily due to the impact of higher volume of $43 million, the benefit of acquisitions of $33 million and favorable manufacturing performance of $29 million. These factors were partially offset by unfavorable price/mix of $22 million and higher material and logistics costs of $20 million.

Table of Contents

Selling, General and Administrative Expenses:

	Three Months Ended September 30,			
	2017	2016	$ Change	Change
Selling, general and administrative expenses	**$134.0**	$107.2	$ 26.8	25.0%
Selling, general and administrative expenses % to net sales	**17.4 %**	16.3 %	—	110 bps

	Nine Months Ended September 30,			
	2017	2016	$ Change	Change
Selling, general and administrative expenses	**$377.4**	$331.3	$ 46.1	13.9%
Selling, general and administrative expenses % to net sales	**17.0 %**	16.4 %	—	60 bps

The increase in SG&A expenses in the third quarter and first nine months of 2017 compared with the third quarter and first nine months of 2016 was primarily due to higher incentive compensation expense and the impact of acquisitions.

Impairment and Restructuring:

	Three Months Ended September 30,			
	2017	2016	$ Change	% Change
Impairment charges	**$ —**	$ 1.2	$ (1.2)	(100.0)%
Severance and related benefit costs	**1.3**	3.3	(2.0)	(60.6)%
Exit costs	**—**	0.8	(0.8)	(100.0)%
Total	**$ 1.3**	$ 5.3	$ (4.0)	(75.5)%

	Nine Months Ended September 30,			
	2017	2016	$ Change	% Change
Impairment charges	**$ —**	$ 3.8	$ (3.8)	(100.0)%
Severance and related benefit costs	**3.2**	12.6	(9.4)	(74.6)%
Exit costs	**0.6**	2.3	(1.7)	(73.9)%
Total	**$ 3.8**	$ 18.7	$ (14.9)	(79.7)%

Impairment and restructuring charges of $1.3 million and $3.8 million in the third quarter and first nine months of 2017, respectively, were primarily comprised of severance and related benefit costs related to initiatives to reduce headcount and right-size the Company's manufacturing footprint, including the planned closure of the Pulaski bearing plant.

Impairment and restructuring charges of $5.3 million and $18.7 million in the third quarter and first nine months of 2016, respectively, were primarily comprised of severance and related benefit costs related to initiatives to reduce headcount and right-size the Company's manufacturing footprint, including the planned closures of the Altavista, Pulaski and Benoni bearing plants. In addition, the Company also recognized impairment charges associated with the planned closure of the Altavista and Benoni bearing plants of $1.2 million and $3.6 million, respectively, during the third quarter and first nine months of 2016.

Table of Contents

Interest Income and Expense:

	Three Months Ended September 30,			
	2017	2016	$ Change	% Change
Interest expense	**$(10.1)**	$(8.0)	$ (2.1)	26.3 %
Interest income	**$0.7**	$0.4	$ 0.3	75.0 %

	Nine Months Ended September 30,			
	2017	2016	$ Change	% Change
Interest expense	**$(26.5)**	$(25.1)	$ (1.4)	5.6 %
Interest income	**$2.0**	$1.1	$ 0.9	81.8 %

Interest expense increased for the third quarter and the first nine months of 2017 compared to the third quarter and the first nine months of 2016, primarily due to borrowings associated with the Groeneveld acquisition. Refer to *Note 8 - Financing Arrangements* to the Consolidated Financial Statements for further discussion.

Other Income (Expense):

	Three Months Ended September 30,			
	2017	2016	$ Change	% Change
CDSOA expense	**$—**	$(0.2)	$ 0.2	(100.0)%
Other income (expense), net	**2.9**	(0.1)	3.0	NM
Total other income (expense)	**$2.9**	$(0.3)	$ 3.2	NM

	Nine Months Ended September 30,			
	2017	2016	$ Change	% Change
CDSOA income	**$—**	$53.6	$ (53.6)	(100.0)%
Other income (expense), net	**9.1**	(1.8)	10.9	NM
Total other income	**$9.1**	$51.8	$ (42.7)	(82.4)%

CDSOA income in the first nine months of 2016 represents income recorded in connection with funds distributed to the Company from monies collected by U.S. Customs from antidumping cases. Refer to *Note 20 - Continued Dumping and Subsidy Offset Act* to the Consolidated Financial Statements for further discussion.

The increase in other income (expense), net for the third quarter of 2017 was primarily due to the gain on the sale of the former manufacturing facility in Altavista and lower foreign currency exchange losses. The increase in other income (expense), net for the first nine months of 2017 was primarily due to lower foreign currency exchange losses and the gain on the sale of former manufacturing facilities in Benoni and

Altavista during the second and third quarter of 2017, respectively.

Table of Contents

Income Tax Expense:

	Three Months Ended September 30,			
	2017	2016	$ Change	Change
Income tax expense	**$21.1**	$15.2	$ 5.9	38.8 %
Effective tax rate	**28.1 %**	30.9 %	—	NM

	Nine Months Ended September 30,			
	2017	2016	$ Change	Change
Income tax expense	**$28.5**	$65.8	$ (37.3)	(56.7)%
Effective tax rate	**14.1 %**	30.8 %	—	NM

The effective tax rate for the three months ended September 30, 2017 is 28.1%. The income tax expense increase from the three months ended September 30, 2016 is driven by $9.1 million of additional expense at the U.S. statutory rate as a result of the increase in income before income taxes and additional expense related to losses in jurisdictions with no tax benefit. These increases are partially offset by favorable U.S. tax deductions and tax credits, and discrete tax amounts.

The effective tax rate for the nine months ended September 30, 2017 is 14.1%. The decrease in income tax expense when compared to the first nine months ended September 30, 2016 was primarily due to the net reversal of accruals for prior year uncertain tax positions (including interest) of $33.9 million in the second quarter of 2017 and favorable U.S. tax deductions and tax credits.

Refer to *Note 17 - Income Taxes* to the Notes to the Consolidated Financial Statements for more information on the computation of the income tax expense in interim periods.

Table of Contents

Business Segments

The Company's reportable segments are business units that serve different industry sectors. While the segments often operate using shared infrastructure, each reportable segment is managed to address specific customer needs in these diverse market sectors. The primary measurement used by management to measure the financial performance of each segment is EBIT. Refer to *Note 13 - Segment Information* in the Notes to the Consolidated Financial Statements for the reconciliation of EBIT by segment to consolidated income before income taxes.

The presentation of segment results below includes a reconciliation of the changes in net sales for each segment reported in accordance with U.S. GAAP to net sales adjusted to remove the effects of acquisitions completed in 2017 and 2016 and foreign currency exchange rate changes. The effects of acquisitions and foreign currency exchange rate changes on net sales are removed to allow investors and the Company to meaningfully evaluate the percentage change in net sales on a comparable basis from period to period.

The following items highlight the Company's acquisitions completed in 2016 and the first nine months of 2017.

- The Company acquired Groeneveld during the third quarter of 2017. Based on markets and customer served, substantially all of the results for Groeneveld are reported in the Mobile Industries segment.
- The Company acquired Torsion Control Products and PT Tech during the second quarter of 2017. Based on markets and customers served, substantially all of the results for both businesses are reported in the Mobile Industries segment.
- The Company acquired EDT during the fourth quarter of 2016. Based on markets and customers served, substantially all of the results for EDT are reported in the Process Industries segment.
- The Company acquired Lovejoy during the third quarter of 2016. Based on markets and customers served, substantially all of the results for Lovejoy are primarily reported in the Process Industries segment.

Mobile Industries Segment:

	Three Months Ended September 30,			
	2017	2016	$ Change	Change
Net sales	**$422.8**	$353.1	$ 69.7	19.7%
EBIT	**$34.9**	$25.9	$ 9.0	34.7%
EBIT margin	**8.3 %**	7.3 %	—	100 bps

	Three Months Ended September 30,			
	2017	2016	$ Change	% Change
Net sales	**$422.8**	$353.1	$ 69.7	19.7%
Less: Acquisitions	**42.2**	—	42.2	NM
Currency	**4.5**	—	4.5	NM
Net sales, excluding the impact of acquisitions and currency	**$376.1**	$353.1	$ 23.0	6.5%

	Nine Months Ended September 30,			
	2017	2016	$ Change	Change
Net sales	**$1,214.2**	$1,104.1	$ 110.1	10.0%

EBIT	**$100.1**	$95.3	$ 4.8	5.0%
EBIT margin	**8.2%**	8.6%	—	(40) bps

36

Table of Contents

	Nine Months Ended September 30, 2017	2016	$ Change	% Change
Net sales	**$1,214.2**	$1,104.1	$ 110.1	10.0%
Less: Acquisitions	**54.2**	—	54.2	NM
Currency	**3.7**	—	3.7	NM
Net sales, excluding the impact of acquisitions and currency	**$1,156.3**	$1,104.1	$ 52.2	4.7%

The Mobile Industries segment's net sales, excluding the effects of acquisitions and foreign currency exchange rate changes, increased $23.0 million or 6.5% in the third quarter of 2017 compared with the third quarter of 2016, reflecting organic growth in the off-highway and heavy truck sectors, partially offset by lower demand in the automotive sector. EBIT increased by $9.0 million or 34.7% in the third quarter of 2017 compared with the third quarter of 2016, primarily due to the impact of higher volume of $9 million, favorable manufacturing performance of $7 million, the benefit of acquisitions of $6 million, lower restructuring charges and the favorable impact of foreign currency exchange rate changes. These factors were partially offset by higher SG&A expense of $9 million, higher material and logistics costs of $6 million and unfavorable price/mix.

The Mobile Industries segment's net sales, excluding the effects of acquisitions and foreign currency exchange rate changes, increased $52.2 million or 4.7% in the first nine months of 2017 compared with the first nine months of 2016, reflecting organic growth in the off-highway and heavy truck sectors, partially offset by decreased demand in the rail and automotive sectors. EBIT increased by $4.8 million or 5.0% in the first nine months of 2017 compared with the first nine months of 2016 primarily due to higher volume of $19 million, the benefit of acquisitions of $9 million, favorable manufacturing performance of $8 million, lower restructuring charges of $6 million and the impact of foreign currency exchange rate changes of $6 million. These factors were partially offset by higher material and logistics costs of $17 million, increased SG&A expense of $14 million and unfavorable price/mix of $12 million.

Full-year sales for the Mobile Industries segment are expected to be up approximately 13% in 2017 compared with 2016. This reflects improved demand in the off-highway and heavy truck sectors, the benefit of acquisitions and the favorable impact of foreign currency exchange rate changes, partially offset by lower demand in the rail sector. EBIT for the Mobile Industries segment is expected to increase in 2017 compared with 2016 primarily due to the impact of higher volume and the impact of acquisitions, mostly offset by unfavorable price/mix and higher SG&A expense. The results for 2016 include the impacts of pension and other postretirement benefit mark-to-market remeasurement charges, which are not accounted for in the 2017 outlook because the amount will not be known until the fourth quarter.

Table of Contents

Process Industries Segment:

	Three Months Ended September 30,			
	2017	2016	$ Change	Change
Net sales	**$348.6**	$304.3	$ 44.3	14.6%
EBIT	**$61.7**	$42.0	$ 19.7	46.9%
EBIT margin	**17.7 %**	13.8 %	—	390 bps

	Three Months Ended September 30,			
	2017	2016	$ Change	% Change
Net sales	**$348.6**	$304.3	$ 44.3	14.6%
Less: Acquisitions	**2.2**	—	2.2	NM
Currency	**4.4**	—	4.4	NM
Net sales, excluding the impact of acquisitions and currency	**$342.0**	$304.3	$ 37.7	12.4%

	Nine Months Ended September 30,			
	2017	2016	$ Change	Change
Net sales	**$1,011.6**	$910.9	$ 100.7	11.1%
EBIT	**$164.9**	$123.7	$ 41.2	33.3%
EBIT margin	**16.3 %**	13.6 %		270 bps

	Nine Months Ended September 30,			
	2017	2016	$ Change	% Change
Net sales	**$1,011.6**	$910.9	$ 100.7	11.1%
Less: Acquisitions	**32.3**	—	32.3	NM
Currency	**0.2**	—	0.2	NM
Net sales, excluding the impact of acquisitions and currency	**$979.1**	$910.9	$ 68.2	7.5%

The Process Industries segment's net sales, excluding the effects of acquisitions and foreign currency exchange rate changes, increased $37.7 million or 12.4% in the third quarter of 2017 compared with the same period in 2016. The increase was primarily driven by organic growth in industrial distribution, heavy industries and wind market sectors. EBIT increased $19.7 million or 46.9% in the third quarter of 2017 compared with the third quarter of 2016 primarily due to the impact of higher volume of $18 million and favorable manufacturing performance of $7 million, partially offset by higher SG&A expense and higher material and logistics costs.

The Process Industries segment's net sales, excluding the effects of acquisitions and foreign currency exchange rate changes, increased $68.2 million or 7.5% in the first nine months of 2017 compared with the first nine months of 2016. The increase was primarily driven by organic growth in industrial distribution and heavy industries market sector. EBIT increased $41.2 million or 33.3% in the first nine months of 2017 compared with the first nine months of 2016 primarily due to the impact of higher volume of $34 million, favorable manufacturing performance of $21 million, lower restructuring charges of $5 million and the benefit of acquisitions, partially offset by unfavorable price/mix of $20 million and higher SG&A expense.

Full-year sales for the Process Industries segment are expected to be up approximately 11% in 2017 compared with 2016. This reflects expected growth across most end market sectors, led by industrial distribution and the benefit of acquisitions and the favorable impact of foreign currency exchange rate changes. EBIT for the Process Industries segment is expected to increase in 2017 compared with 2016 primarily due to the impact of higher volume, the benefit of acquisitions and lower restructuring charges, partially offset by unfavorable price/mix and higher SG&A expense. The results for 2016 include the impacts of pension and other postretirement benefit mark-to-market remeasurement charges, which are not accounted for in the 2017 outlook because the amount will not be known until the fourth quarter.

Table of Contents

Corporate:

	Three Months Ended September 30,			
	2017	2016	$ Change	Change
Corporate expenses	**$12.0**	$10.9	$ 1.1	10.1%
Corporate expenses % to net sales	**1.6 %**	1.7 %	—	(10) bps

	Nine Months Ended September 30,			
	2017	2016	$ Change	Change
Corporate expenses	**$37.8**	$34.8	$ 3.0	8.6%
Corporate expenses % to net sales	**1.7 %**	1.7 %	—	—

Table of Contents

The Balance Sheet

The following discussion is a comparison of the Consolidated Balance Sheets at September 30, 2017 and December 31, 2016.

Current Assets:

	September 30, 2017	December 31, 2016	$ Change	% Change
Cash and cash equivalents	**$ 137.2**	$ 148.8	$ (11.6)	(7.8)%
Restricted cash	**3.3**	2.7	0.6	22.2 %
Accounts receivable, net	**542.2**	438.0	104.2	23.8 %
Inventories, net	**687.5**	553.7	133.8	24.2 %
Deferred charges and prepaid expenses	**39.9**	20.3	19.6	96.6 %
Other current assets	**64.2**	48.4	15.8	32.6 %
Total current assets	**$ 1,474.3**	$ 1,211.9	$ 262.4	21.7 %

Refer to the *"Cash Flows"* section for discussion on the change in cash and cash equivalents. Accounts receivable, net increased primarily due to higher sales in September 2017 compared to December 2016, current-year acquisitions and the impact of foreign currency exchange rate changes.
Inventories, net increased due to higher demand, current-year acquisitions and the impact of foreign currency exchange rate changes. Deferred charges and prepaid expenses at September 30, 2017 included a prepayment of U.S. income taxes for 2017. Other current assets primarily increased due to an increase in short-term investments and current-year acquisitions.

Property, Plant and Equipment, Net:

	September 30, 2017	December 31, 2016	$ Change	% Change
Property, plant and equipment	**$ 2,360.6**	$ 2,233.0	$ 127.6	5.7 %
Accumulated depreciation	**(1,518.4)**	(1,428.6)	(89.8)	6.3 %
Property, plant and equipment, net	**$ 842.2**	$ 804.4	$ 37.8	4.7 %

The increase in property, plant and equipment, net in the first nine months of 2017 was primarily due to capital expenditures of $56 million, current-year acquisitions of $32 million and the impact of foreign currency exchange rate changes of $27 million, partially offset by current-year depreciation of $73 million.

Other Assets:

	September 30, 2017	December 31, 2016	$ Change	% Change
Goodwill	**$ 510.3**	$ 357.5	$ 152.8	42.7 %
Non-current pension assets	**31.6**	32.1	(0.5)	(1.6)%
Other intangible assets	**428.9**	271.0	157.9	58.3 %
Deferred income taxes	**47.9**	51.4	(3.5)	(6.8)%
Other non-current assets	**28.4**	34.9	(6.5)	(18.6)%
Total other assets	**$ 1,047.1**	$ 746.9	$ 300.2	40.2 %

The increase in goodwill was primarily due to $148 million of goodwill acquired from current-year acquisitions. The increase in other intangible assets was primarily due to $175 million of intangible assets acquired from the current-year acquisitions and current-year expenditures for software of $6 million, partially offset by current-year amortization of $29 million.

Table of Contents

Current Liabilities:

	September 30, 2017	December 31, 2016	$ Change	% Change
Short-term debt	**$ 41.1**	$ 19.2	$ 21.9	114.1 %
Current portion of long-term debt	**5.0**	5.0	—	— %
Accounts payable	**248.1**	176.2	71.9	40.8 %
Salaries, wages and benefits	**112.2**	85.9	26.3	30.6 %
Income taxes payable	**7.4**	16.9	(9.5)	(56.2)%
Other current liabilities	**154.9**	149.5	5.4	3.6 %
Total current liabilities	**$ 568.7**	$ 452.7	$ 116.0	25.6 %

The increase in short-term debt was primarily due to higher borrowings of $16 million under foreign lines of credit. The increase in accounts payable was primarily due to increased purchasing activity, as well as higher days outstanding driven by the Company's initiative to extend payment terms with its suppliers. The increase in accrued salaries, wages and benefits was primarily due to higher accruals for incentive compensation expense, as well as current-year acquisitions. The decrease in income taxes was primarily due to the Company being in a prepaid position with respect to U.S. income taxes at September 30, 2017 as reflected on the balance sheet; at December 31, 2016, the Company had a current income tax payable balance that included $13.7 million payable for U.S. income taxes.

Non-Current Liabilities:

	September 30, 2017	December 31, 2016	$ Change	% Change
Long-term debt	**$ 959.8**	$ 635.0	$ 324.8	51.1 %
Accrued pension cost	**160.3**	154.7	5.6	3.6 %
Accrued postretirement benefits cost	**126.7**	131.5	(4.8)	(3.7)%
Deferred income taxes	**44.9**	3.9	41.0	NM
Other non-current liabilities	**47.3**	74.5	(27.2)	(36.5)%
Total non-current liabilities	**$ 1,339.0**	$ 999.6	$ 339.4	34.0 %

The increase in long-term debt was primarily due to additional borrowings of $176.5 million under the 2027 Notes and $117.8 million under the 2020 Term Loan to finance the Groeneveld acquisition, as well as additional borrowings of $20 million classified as long-term under the Accounts Receivable Facility and additional borrowings of $8 million under the Company's Senior Credit Facility.

The increase in deferred income taxes was primarily due to current-year acquisitions of $42 million. The decrease in other non-current liabilities was primarily driven by the reversal of accruals for uncertain tax positions of $34 million due to the expiration of statutes of limitation in various jurisdictions.

Table of Contents

Shareholders' Equity:

	September 30, 2017	December 31, 2016	$ Change	% Change
Common stock	**$ 951.3**	$ 960.0	$ (8.7)	(0.9)%
Earnings invested in the business	**1,400.2**	1,289.3	110.9	8.6 %
Accumulated other comprehensive loss	**(41.0)**	(77.9)	36.9	(47.4)%
Treasury shares	**(887.5)**	(891.7)	4.2	(0.5)%
Noncontrolling interest	**32.9**	31.2	1.7	5.4 %
Total shareholders' equity	**$ 1,455.9**	$ 1,310.9	$ 145.0	11.1 %

Earnings invested in the business in the first nine months of 2017 increased by net income attributable to the Company of $174.2 million, partially offset by dividends declared of $62.4 million.

The decrease in accumulated other comprehensive loss was primarily due to foreign currency adjustments of $40.9 million. The foreign currency translation adjustments were due to the weakening of the U.S. dollar relative to other foreign currencies, including the Romanian Leu, Chinese Yuan, Indian Rupee and Polish Zloty. See *"Other Matters - Foreign Currency"* for further discussion regarding the impact of foreign currency translation.

Table of Contents

Cash Flows

	Nine Months Ended September 30, 2017	2016	$ Change
Net cash provided by operating activities	**$142.9**	$278.7	$(135.8)
Net cash used in investing activities	**(407.4)**	(143.3)	(264.1)
Net cash provided by (used in) financing activities	**236.3**	(139.7)	376.0
Effect of exchange rate changes on cash	**16.6**	3.7	12.9
Decrease in cash and cash equivalents	**$(11.6)**	$(0.6)	$(11.0)

Operating Activities:
Operating activities provided net cash of $142.9 million in the first nine months of 2017, compared with net cash of $278.7 million provided in the first nine months of 2016. The decrease was primarily due to the unfavorable impact of income taxes of $79.6 million and a net unfavorable change in working capital items of $71.5 million, partially offset by higher net income of $26.2 million. Refer to the tables below for additional detail of the impact of each line on net cash provided by operating activities.

The following table displays the impact of working capital items on cash during the first nine months of 2017 and 2016, respectively:

	Nine Months Ended September 30, 2017	2016	$ Change
Cash Provided (Used):			
Accounts receivable	**$(61.6)**	$12.2	$(73.8)
Inventories	**(85.4)**	(13.6)	(71.8)
Trade accounts payable	**55.7**	15.0	40.7
Other accrued expenses	**15.9**	(17.5)	33.4
Cash used by working capital items	**$(75.4)**	$(3.9)	$(71.5)

The following table displays the impact of income taxes on cash during the first nine months of 2017 and 2016, respectively:

	Nine Months Ended September 30, 2017	2016	$ Change
Accrued income tax expense	**$28.5**	$65.8	$(37.3)
Income tax payments	**(77.2)**	(32.5)	(44.7)
Other miscellaneous items	**(3.4)**	(5.8)	2.4
Change in income taxes	**$(52.1)**	$27.5	$(79.6)

Investing Activities:
Net cash used in investing activities of $407.4 million in the first nine months of 2017 increased $264.1 million from the same period in 2016 primarily due to an increase of $284.4 million in cash used for acquisitions, partially offset by a $21.9 million reduction in capital expenditures.

Financing Activities:

Net cash provided by financing activities was $236.3 million in the first nine months of 2017 compared with net cash of $139.7 million used in financing activities in the first nine months of 2016. The increase was primarily due to an increase in net borrowings of $323.1 million, primarily needed to fund the Groeneveld acquisition that closed on July 3, 2017, and less cash used in share repurchases of $42 million during the first nine months of 2017 compared with the first nine months of 2016.

Table of Contents

Liquidity and Capital Resources:

Reconciliation of total debt to net debt and the ratio of net debt to capital:

Net Debt:

	September 30, 2017	December 31, 2016
Short-term debt	**$ 41.1**	$ 19.2
Current portion of long-term debt	**5.0**	5.0
Long-term debt	**959.8**	635.0
Total debt	**$ 1,005.9**	$ 659.2
Less: Cash and cash equivalents	**137.2**	148.8
Restricted cash	**3.3**	2.7
Net debt	**$ 865.4**	$ 507.7

Ratio of Net Debt to Capital:

	September 30, 2017		December 31, 2016	
Net debt	**$ 865.4**		$ 507.7	
Shareholders' equity	**1,455.9**		1,310.9	
Net debt plus shareholders' equity (capital)	**$ 2,321.3**		$ 1,818.6	
Ratio of net debt to capital	**37.3**	**%**	27.9	%

The Company presents net debt because it believes net debt is more representative of the Company's financial position than total debt due to the amount of cash and cash equivalents held by the Company.

At September 30, 2017, $137.0 million of the Company's $137.2 million of cash and cash equivalents resided in jurisdictions outside the U.S. It is the Company's practice to use available cash in the U.S. to pay down its Senior Credit Facility or Accounts Receivable Facility in order to minimize total interest expense. Repatriation of non-U.S. cash could be subject to domestic and foreign taxes and some portion may be subject to governmental restrictions. Part of the Company's strategy is to grow in attractive market sectors, many of which are outside the U.S. This strategy includes making investments in facilities, equipment and potential new acquisitions. The Company plans to fund these investments, as well as meet working capital requirements, with cash and cash equivalents and unused lines of credit within the geographic location of these investments where feasible.

The Company has a $100 million Accounts Receivable Facility, which matures on November 30, 2018. The Accounts Receivable Facility is subject to certain borrowing base limitations and is secured by certain domestic accounts receivable of the Company. Certain borrowing base limitations reduced the availability of the Accounts Receivable Facility to $80.3 million at September 30, 2017. As of September 30, 2017, the Company had $74.8 million in outstanding borrowings, which reduced the availability under the facility to $5.5 million. The interest rate on the Accounts Receivable Facility is variable and was 2.07% as of September 30, 2017, which reflects the prevailing commercial paper rate plus facility fees.

The Company has a $500 million Senior Credit Facility, which matures on June 19, 2020. At September 30, 2017, the Senior Credit Facility had outstanding borrowings of $91.2 million, which reduced the availability to $408.8 million. The Senior Credit Facility has two financial covenants: a consolidated leverage ratio and a consolidated interest coverage ratio. At September 30, 2017, the Company was in full compliance with the covenants under the Senior Credit Facility and its other debt agreements. The maximum consolidated leverage ratio permitted under the Senior Credit Facility is 3.5 to 1.0 (3.75 to 1.0 for a limited period up to four quarters following an acquisition with a purchase price of $200 million or greater). As of September 30, 2017, the Company's consolidated leverage ratio was 2.23 to 1.0. The minimum consolidated interest coverage ratio permitted under the Senior Credit Facility is 3.5 to 1.0. As of September 30, 2017, the Company's consolidated interest coverage ratio was 13.57 to 1.0.

The interest rate under the Senior Credit Facility is variable and represents a blended U.S. Dollar and Euro rate with a spread based on the Company's debt rating. This rate was 1.59% as of September 30, 2017. In addition, the Company pays a facility fee based on the consolidated leverage ratio multiplied by the aggregate commitments of all of the lenders under the Senior Credit Facility.

Other sources of liquidity include short-term lines of credit for certain of the Company's foreign subsidiaries, which provide for borrowings of up to approximately $250.0 million in the aggregate. Most of these credit lines are uncommitted. At September 30, 2017, the Company had borrowings outstanding of $35.5 million and bank guarantees of $2.0 million, which reduced the aggregate availability under these facilities to $212.5 million.

The Company expects that any cash requirements in excess of cash on hand and cash generated from operating activities will be met by the committed funds available under its Accounts Receivable Facility and the Senior Credit Facility. Management believes it has sufficient liquidity to meet its obligations through at least the term of the Senior Credit Facility.

The Company expects to remain in compliance with its debt covenants. However, the Company may need to limit its borrowings under the Senior Credit Facility or other facilities in order to remain in compliance. As of September 30, 2017, the Company could have borrowed the full amounts available under the Senior Credit Facility and Accounts Receivable Facility and still would have been in compliance with its debt covenants.

The Company issued €150 million of 2027 Notes, which mature on September 7, 2027. On September 18, 2017, the Company entered into a €100 million 2020 Term Loan, which matures on September 18, 2020. Refer to *Note 8 - Financing Arrangements* for additional information.

The Company expects cash from operations of approximately $280 million in 2017, a decrease from 2016 of approximately $124 million or 31%, driven by the absence of CDSOA receipts, higher tax payments and unfavorable working capital, partially offset by higher operating income. The Company expects capital expenditures to be between 3% and 3.5% of net sales in 2017, compared with 5% of net sales in 2016.

Financing Obligations and Other Commitments:

During the first nine months of 2017, the Company made contributions of $8.8 million to its global defined benefit pension plans. The Company currently expects to make contributions to its global defined benefit pension plans in 2017 totaling approximately $10 million. Returns for the Company's U.S. defined benefit plan pension assets for the first nine months of 2017 were approximately 10.1%. Returns for the Company's global defined benefit pension plan assets in 2016 were 8.5%, which was above the weighted-average expected rate of return of 5.78% predominantly due to both strong returns in equity and fixed-income markets. The Company expects to record pension expense of approximately $15 million in 2017, including the mark-to-market remeasurement losses of approximately $4 million recorded during the first quarter, compared with pension expense of $73.4 million in 2016, which included approximately $60 million of mark-to-market remeasurement losses. The amount for 2017 does not include actuarial gains and losses that will be recognized immediately through earnings as a result of the remeasurement of pension plan assets and obligations in the fourth quarter of 2017.

The Company does not have any off-balance sheet arrangements with unconsolidated entities or other persons.

Critical Accounting Policies and Estimates:
The Company's financial statements are prepared in accordance with accounting principles generally accepted in the U.S. The preparation of these financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the periods presented. The Company reviews its critical accounting policies throughout the year. The Company has concluded that there have been no significant changes to its critical accounting policies or estimates, as described in its Annual Report on Form 10-K for the year ended December 31, 2016, during the nine months ended September 30, 2017 other than the change in accounting principles described below.

Benefit Plans:
Effective January 1, 2017, the Company voluntarily changed its accounting principles for recognizing actuarial gains and losses and expected returns on plan assets for its defined benefit pension and other postretirement benefit plans, with retrospective application to prior periods. Prior to 2017, the Company amortized, as a component of pension and other postretirement expense, unrecognized actuarial gains and losses (included within Accumulated other comprehensive income (loss)) over the average remaining service period of active plan participants expected to receive benefits under the plan, or average remaining life expectancy of inactive plan participants when all or almost all of individual plan participants were inactive. The Company also historically calculated the market-related value of plan assets based on a five-year market adjustment. Under the new principles, actuarial gains and losses will be immediately recognized through net periodic benefit cost in the Statement of Income, upon the annual remeasurement in the fourth quarter, or on an interim basis if specific events trigger a remeasurement. In addition, the Company has changed its accounting policy for measuring the market-related value of plan assets from a calculated amount (based on a five-year smoothing of asset returns) to fair value. The Company believes these changes are preferable as they result in an accelerated recognition of actuarial gains and losses and changes in fair value of plan assets in its Consolidated Statement of Income, which provides greater transparency and better aligns with fair value principles by fully reflecting the impact of interest rate and economic changes on the Company's pension and other postretirement benefit liabilities and assets in the Company's operating results in the year in which the gains and losses are incurred.

Other Matters

Foreign Currency:

Assets and liabilities of subsidiaries are translated at the rate of exchange in effect on the balance sheet date; income and expenses are translated at the average rates of exchange prevailing each month during the quarter. Related translation adjustments are reflected as a separate component of accumulated other comprehensive income (loss). Foreign currency gains and losses resulting from transactions are included in the Consolidated Statement of Income.

For the nine months ended September 30, 2017, the Company recorded positive foreign currency translation adjustments of $40.9 million that increased shareholders' equity, compared with a positive foreign currency translation adjustments of $3.3 million that increased shareholders' equity for the nine months ended September 30, 2016. The foreign currency translation adjustments for the nine months ended September 30, 2017 were positively impacted by the weakening of the U.S. dollar relative to other foreign currencies, including the Romanian Leu, Chinese Yuan, Indian Rupee and Polish Zloty.

Foreign currency exchange losses resulting from transactions included in the Company's operating results for the third quarter of 2017 were $1.2 million, compared with losses of $2.8 million during the third quarter of 2016. Foreign currency exchange losses resulting from transactions included in the Company's operating results for the first nine months of 2017 were $2.6 million, compared with losses of $5.8 million during the first nine months of 2016.

Table of Contents

Forward-Looking Statements

Certain statements set forth in this Form 10-Q and in the Company's Annual Report on Form 10-K for the year ended December 31, 2016 that are not historical in nature (including the Company's forecasts, beliefs and expectations) are “forward-looking” statements within the meaning of the Private Securities Litigation Reform Act of 1995. In particular, Management's Discussion and Analysis contains numerous forward-looking statements. Forward-looking statements generally will be accompanied by words such as “anticipate,” “believe,” “could,” “estimate,” “expect,” “forecast,” “outlook,” “intend,” “may,” “possible,” “potential,” “pre “project” or other similar words, phrases or expressions. You are cautioned not to place undue reliance on forward-looking statements, which speak only as of the date of this Form 10-Q. The Company cautions readers that actual results may differ materially from those expressed or implied in forward-looking statements made by or on behalf of the Company due to a variety of factors, such as:

- deterioration in world economic conditions, or in economic conditions in any of the geographic regions in which the Company conducts business, including additional adverse effects from the global economic slowdown, terrorism or hostilities. This includes: political risks associated with the potential instability of governments and legal systems in countries in which the Company or its customers conduct business and changes in currency valuations;
- the effects of fluctuations in customer demand on sales, product mix and prices in the industries in which the Company operates. This includes: the ability of the Company to respond to rapid changes in customer demand, the effects of customer bankruptcies or liquidations, the impact of changes in industrial business cycles and whether conditions of fair trade continue in the U.S. markets;
- competitive factors, including changes in market penetration, increasing price competition by existing or new foreign and domestic competitors, the introduction of new products by existing and new competitors and new technology that may impact the way the Company’s products are sold or distributed;
- changes in operating costs. This includes: the effect of changes in the Company’s manufacturing processes; changes in costs associated with varying levels of operations and manufacturing capacity; availability and cost of raw materials and energy; changes in the expected costs associated with product warranty claims; changes resulting from inventory management, cost reduction initiatives and different levels of customer demands; the effects of unplanned plant shutdowns; and changes in the cost of labor and benefits;
- the success of the Company’s operating plans, announced programs, initiatives and capital investments; the ability to complete previously announced transactions; the ability to integrate acquired companies; and the ability of acquired companies to achieve satisfactory operating results, including results being accretive to earnings;
- the Company’s ability to maintain appropriate relations with unions that represent Company associates in certain locations in order to avoid disruptions of business;
- unanticipated litigation, claims, or assessments. This includes: claims or problems related to intellectual property, product liability or warranty, environmental issues and taxes;
- changes in worldwide financial markets, including availability of financing and interest rates, which affect the Company’s cost of funds and/or ability to raise capital, as well as customer demand and the ability of customers to obtain financing to purchase the Company’s products or equipment that contain the Company’s products;
- the impact on the Company's pension obligations due to changes in interest rates, investment performance and other tactics designed to reduce risk;
- retention of CDSOA distributions; and
- those items identified under Item 1A. Risk Factors in the Company's Annual Report on Form 10-K for the year ended December 31, 2016.

Additional risks relating to the Company's business, the industries in which the Company operates, or the Company's common shares may be described from time to time in the Company's filings with the Securities and Exchange Commission. All of these risk factors are difficult to predict, are subject to material uncertainties that may affect actual results and may be beyond the Company's control.

Readers are cautioned that it is not possible to predict or identify all of the risks, uncertainties and other factors that may affect future results and that the above list should not be considered to be a complete list. Except as required by the federal securities laws, the Company undertakes no obligation to publicly update or revise any forward-looking statement, whether as a result of new information, future events, or otherwise.

Table of Contents

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Refer to information appearing under the caption “Management’s Discussion and Analysis of Financial Condition and Results of Operations” of this Form 10-Q. Furthermore, a discussion of market risk exposures is included in Part II, Item 7A. Quantitative and Qualitative Disclosure about Market Risk, of the Company’s Annual Report on Form 10-K for the year ended December 31, 2016. There have been no material changes in reported market risk since the inclusion of this discussion in the Company’s Annual Report on Form 10-K referenced above.

ITEM 4. CONTROLS AND PROCEDURES

(a) Disclosure Controls and Procedures

As of the end of the period covered by this report, the Company carried out an evaluation, under the supervision and with the participation of the Company’s management, including the Company’s principal executive officer and principal financial officer, of the effectiveness of the design and operation of the Company’s disclosure controls and procedures (as defined in Exchange Act Rule 13a-15(e)). Based upon that evaluation, the principal executive officer and principal financial officer concluded that the Company’s disclosure controls and procedures were effective as of the end of the period covered by this report.

(b) Changes in Internal Control Over Financial Reporting

During the Company’s most recent fiscal quarter, there have been no changes in the Company’s internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, the Company’s internal control over financial reporting.

Table of Contents

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

The Company is involved in various claims and legal actions arising in the ordinary course of business. In the opinion of management, the ultimate disposition of these matters will not have a material adverse effect on the Company's consolidated financial position or results of operations.

Item 1A. Risk Factors

Our Annual Report on Form 10-K for the fiscal year ended December 31, 2016, included a detailed discussion of our risk factors. There have been no material changes to the risk factors included in the Company's Annual Report on Form 10-K for the year endedDecember 31, 2016.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

Issuer Purchases of Common Shares

The following table provides information about purchases by the Company of its common shares during the quarter ended September 30, 2017.

Period	Total number of shares purchased (1)	Average price paid per share (2)	Total number of shares purchased as part of publicly announced plans or programs	Maximum number of shares that may yet be purchased under the plans or programs (3)
7/1/17 - 7/31/17	66,761	$ 46.96	64,000	9,368,000
8/1/17 - 8/31/17	233,321	44.31	206,000	9,162,000
9/1/17 - 9/30/17	43,397	46.36	42,000	9,120,000
Total	343,479	$ 45.09	312,000	9,120,000

(1) Of the shares purchased in July, August and September, 2,761, 27,321 and 1,397, respectively, represent common shares of the Company that were owned and tendered by employees to exercise stock options and to satisfy withholding obligations in connection with the exercise of stock options and vesting of restricted shares.

(2) For shares tendered in connection with the vesting of restricted shares, the average price paid per share is an average calculated using the daily high and low of the Company's common shares as quoted on the New York Stock Exchange at the time of vesting. For shares tendered in connection with the exercise of stock options, the price paid is the real-time trading stock price at the time the options are exercised.

(3) On February 6, 2017, the Board of Directors of the Company approved a share purchase plan pursuant to which the Company may purchase up to ten million of its common shares in the aggregate. This share repurchase plan expires on February 28, 2021. The Company may purchase shares from time to time in open market purchases or privately negotiated transactions. The Company may make all or part of the purchases pursuant to accelerated share repurchases or Rule 10b5-1 plans.

Table of Contents

Item 6. Exhibits

12	Computation of Ratio of Earnings to Fixed Charges.
31.1	Certification of Richard G. Kyle, President and Chief Executive Officer (principal executive officer) of The Timken Company, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Philip D. Fracassa, Executive Vice President and Chief Financial Officer (principal financial officer) of The Timken Company, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32	Certifications of Richard G. Kyle, President and Chief Executive Officer (principal executive officer) and Philip D. Fracassa, Executive Vice President and Chief Financial Officer (principal financial officer) of The Timken Company, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101	Financial statements from the quarterly report on Form 10-Q of The Timken Company for the quarter ended September 30, 2017, filed on October 25, 2017, formatted in XBRL: (i) the Consolidated Statements of Income, (ii) the Consolidated Statements of Comprehensive Income, (iii) the Consolidated Balance Sheets, (iv) the Consolidated Statements of Cash Flows and (v) the Notes to the Consolidated Financial Statements.

Table of Contents

SIGNATURES

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

	THE TIMKEN COMPANY
Date: October 25, 2017	By: /s/ Richard G. Kyle Richard G. Kyle President and Chief Executive Officer (Principal Executive Officer)
Date: October 25, 2017	By: /s/ Philip D. Fracassa Philip D. Fracassa Executive Vice President and Chief Financial Officer (Principal Financial Officer)