XYRATEX LTD
Form 20-F
February 20, 2007

XYRATEX LTD

ANNUAL REPORT FOR THE YEAR ENDED

NOVEMBER 30, 2006

As filed with the Securities and Exchange Commission on February 20, 2007

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 20-F

o **REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) OR 12(g) OF THE SECURITIES EXCHANGE ACT OF 1934**

or

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

For the Fiscal Year Ended November 30, 2006

or

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

or

o **SHELL COMPANY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

(Commission file number 000-50799)

XYRATEX LTD

(Exact Name of Registrant as Specified in Its Charter)

Bermuda

(Jurisdiction of Incorporation or Organization)

Langstone Road

Havant PO9 1SA

United Kingdom

(011) 44 2392 496000

(Address of Principal Executive Offices)

Securities registered or to be registered pursuant to Section 12(b) of the Act:

None

(Title of class)

Securities registered pursuant to Section 12(g) of the Act:

Title of each class	Name of each Exchange on which registered
Common Shares, par value $0.01 per share	Nasdaq Stock Market

Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act:

None

(Title of class)

Indicate the number of outstanding shares of each of the issuer s classes of capital or

common stock as of the close of the period covered by the Annual Report:

28,927,317 common shares, par value $0.01 per share

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes o No x

If this report is an annual or transition report, indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.

Yes o No x

Note checking the box above will not relieve any registrant required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 from their obligations under those sections.

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes x No o

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

Large accelerated filer o Accelerated filer x Non-accelerated filer o

Indicate by check mark which financial statement item the registrant has elected to follow.

Item 17 o Item 18 x

If this is an annual report, indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o No x

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INTRODUCTION

We are incorporated under the laws of Bermuda and maintain a registered office in Bermuda at Clarendon House, Church Street, Hamilton, Bermuda. Our principal executive offices are located at Langstone Road, Havant PO9 1SA, United Kingdom and the telephone number for these offices is (011) 44 2392 496000. Our agent for service of process in the United States is Chris Sharman, 2031 Concourse Drive, San Jose, California 95131-1727, USA (telephone: (408) 894 0800).

We conducted an initial public offering in the United States and listing of our common shares on the Nasdaq National Market on June 29, 2004. Our common shares trade on The NASDAQ Stock Market LLC under the symbol XRTX and are listed on the NASDAQ Global Select Market.

In this Annual Report, except as otherwise indicated or as the context otherwise requires, the Company , Group , Xyratex , we , us and our r Xyratex Ltd and its subsidiaries.

INDUSTRY DATA

In this Annual Report, we refer to information regarding the Networked Storage Solutions Market and the Storage Infrastructure Market from International Data Corporation, or IDC, an independent research company and TrendFocus, an independent research company.

CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

This Annual Report includes forward-looking statements. All statements other than statements of historical fact included in this Annual Report regarding our business, financial condition, results of operations and certain of our plans, objectives, assumptions, expectations or beliefs with respect to these items and statements regarding other future events or prospects, are forward-looking statements. These statements include, without limitation, those concerning: our strategy and our ability to achieve it; expectations regarding sales, profitability and growth; our possible or assumed future results of operations; capital expenditure and investment plans; adequacy of capital; and financing plans. The words aim, may, expect, anticipate, believe, future, continue, help, estimate, plan, intend, should, could, would, shall thereof as well as other statements regarding matters that are not historical fact, are or may constitute forward-looking statements. In addition, this Annual Report includes forward-looking statements relating to our potential exposure to various types of market risks, such as foreign exchange rate risk, interest rate risks and other risks related to financial assets and liabilities. We have based these forward-looking statements on our management s current view with respect to future events and financial performance. These views reflect the best judgment of our management but involve a number of risks and uncertainties which could cause actual results to differ materially from those predicted in our forward-looking statements and from past results, performance or achievements. Although we believe that the estimates reflected in the forward-looking statements are reasonable, such estimates may prove to be incorrect. By their nature, forward-looking statements involve risk and uncertainty because they relate to events and depend on circumstances that will occur in the future. There are a number of factors that could cause actual results and developments to differ materially from these expressed or implied by these forward-looking statements. For further discussion of these factors and other risks, see Part I, Item 3D Risk Factors and Item 5 Operating and Financial Review and Prospects.

PART I

ITEM 1: IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISERS

Not applicable.

ITEM 2: OFFER STATISTICS AND EXPECTED TIMETABLE

Not applicable.

ITEM 3: KEY INFORMATION

Item 3A: Selected Financial Data

The selected historical consolidated statement of operations data for the years ended November 30, 2004, 2005, 2006 and balance sheet data for the years ended November 30, 2005 and 2006 presented below have been derived from the audited consolidated financial statements of Xyratex Ltd included elsewhere in this Annual Report and which have been prepared in accordance with U.S. generally accepted accounting principles, or U.S. GAAP.

Xyratex Ltd became our parent company immediately prior to the closing of our initial public offering on June 29, 2004. Prior to this date our parent company was Xyratex Group Limited. For the periods from December 1, 2000 to June 29, 2004 the selected historical financial data represent the results of operations and financial position of Xyratex Group Limited.

	Year Ended November 30,				
	2006	2005	2004	2003	2002
	(U.S. dollars in thousands)				
Consolidated Statement of Operations Data:					
Revenues:					
Networked Storage Solutions	$ 598,752	$ 415,379	$ 318,692	$ 221,714	$ 177,783
Storage Infrastructure	384,881	264,230	140,322	112,055	74,749
Total revenues	983,633	679,609	459,014	333,769	252,532
Gross profit:					
Networked Storage Solutions	82,762	64,831	56,282	39,010	28,103
Storage Infrastructure	115,447	79,463	46,174	34,739	25,671
Non-cash equity compensation(1)	(923)		(7,827)	(690)	
Total gross profit	197,286	144,294	94,629	73,059	53,774
Operating expenses:					
Research and development:					
Development arrangement(2)			(6,000)		7,800
Non-cash equity compensation(1)	1,962		23,959	2,428	
Other	69,429	54,327	37,429	29,797	22,424
Total research and development	71,391	54,327	55,388	32,225	30,224
Selling, general and administrative:					
Non-cash equity compensation(1)	4,309	828	136,363	54,143	
Other	56,140	38,014	28,005	22,426	17,448
Total selling, general and administrative	60,449	38,842	164,368	76,569	17,448
Gain on derivative financial instruments					(1,763)
Amortization of intangible assets	5,123	3,218	1,169		
In process research and development		3,230	852		
Other costs(1)			2,388	11,625	2,771
Total operating expenses	136,963	99,617	224,165	120,419	48,680
Operating income (loss)	60,323	44,677	(129,536)	(47,360)	5,094
Other income	3,167				
Interest income (expense), net(3)	1,162	1,176	1,052	(209)	(923)
Income (loss) from continuing operations before income taxes	64,652	45,853	(128,484)	(47,569)	4,171
Provision (benefit) for income taxes	6,474	3,964	(6,239)	(11,754)	(791)
Net income (loss) from continuing operations	58,178	41,889	(122,245)	(35,815)	4,962
Income (loss) from discontinued operations		280	(12,924)	(20,194)	(3,326)
Gain (loss) from sale of discontinued operations				(185)	
Net income (loss)	$ 58,178	$ 42,169	$ (135,169)	$ (56,194)	$ 1,636
Net earnings (loss) from continuing operations per common share, class B ordinary and preferred ordinary share basic(4)	$ 2.03	$ 1.48	$ (6.72)	$ (9.60)	$ 2.67
Net earnings (loss) per common share, class B ordinary and preferred ordinary share basic(4)	$ 2.03	$ 1.49	$ (7.43)	$ (15.07)	$ 0.88
Net earnings (loss) from continuing operations per common share, class B ordinary and preferred ordinary share diluted(5)	$ 1.97	$ 1.44	$ (6.72)	$ (9.60)	$ 2.67
Net earnings (loss) per common share, class B ordinary and preferred ordinary share diluted(5)	$ 1.97	$ 1.45	$ (7.43)	$ (15.07)	$ 0.88

(1) In accordance with U.S. GAAP, we recorded a non-cash equity compensation expense of $168.1 million in continuing operations and $12.9 million in discontinued operations in our 2004 fiscal year in connection with our initial public offering. We also recorded a non-cash equity compensation expense of $57.3 million in continuing operations and $19.9 million in discontinued operations in our 2003 fiscal year in connection with a transaction in which funds managed by HgCapital acquired a significant shareholding in Xyratex Group Limited. These expenses resulted from the removal of transferability restrictions on the shares and options as a consequence of the initial public offering or which were sold to funds managed by HgCapital. We also recorded expenses of the initial public offering and the HgCapital transaction totaling $2.4 million and $11.6 million in our 2004 and 2003 fiscal years, respectively.

(2) Relates to a loan of $6.0 million and other payments of $1.8 million associated with a development arrangement with a supplier. These payments were recorded as an expense in our fiscal year ended November 30, 2002 as it was believed that repayment was dependent on the successful efforts of the related research and development. In February 2004, this supplier was acquired by another company and in August 2004 the loan was repaid. Accordingly, we have reduced operating expenses by $6.0 million in our 2004 fiscal year. However, it is not possible to predict whether the payment of $1.8 million will have any significant future benefit.

(3) Interest income in our 2004 fiscal year includes interest received of $1.1 million on the $6.0 million loan described in footnote (2) above.

(4) Based on the weighted average (in thousands) of 28,663, 28,329, 18,195, 3,730 and 1,856 Xyratex Ltd common shares and Xyratex Group Limited, class B ordinary and preferred ordinary shares outstanding for the years ended November 30, 2006, 2005, 2004, 2003, and 2002, respectively. The computation of earnings per share does not include outstanding Xyratex Group Limited class A ordinary and preferred ordinary shares and class C ordinary shares, which were subject to transferability restrictions that lapsed on the earlier of an initial public offering or a sale or liquidation of Xyratex Group Limited. Under U.S. GAAP, these shares are not treated as outstanding when computing net earnings per share.

(5) Based on the weighted average (in thousands) of 29,604 and 29,031 Xyratex Ltd common shares outstanding for the years ended November 30, 2006 and 2005, respectively. The number of shares used in the computation of diluted earnings per share for earlier fiscal years is the same as that used in the computation of basic earnings per share.

	As of November 30, 2006	2005	2004	2003	2002
	(U.S. dollars in thousands)				
Consolidated Balance Sheet Data:					
Cash and cash equivalents	$ 56,921	$ 41,240	$ 63,495	$ 2,008	$ 455
Working capital	129,320	74,284	90,847	14,275	7,351
Total assets	375,680	301,290	205,242	111,271	76,663
Short-term borrowings and current portion of acquisition note payable	4,000	7,000	6,000	4,133	4,763
Long-term debt and acquisition note payable, net of current portion	3,000	7,000	11,000	15,000	7,850
Total debt	7,000	14,000	17,000	19,133	12,613
Total shareholders equity	$ 234,494	$ 161,382	$ 116,701	$ 19,001	$ 8,962
Number of shares issued and outstanding:					
Common shares	28,793	28,437	28,043		
Class B preferred ordinary shares				11,099	
Class A preferred ordinary shares				8,845	
Class A ordinary shares					7,166
Class B ordinary shares					1,856
Class C ordinary shares					12,850

Item 3B: Capitalization and Indebtedness

Not applicable.

Item 3C: Reason for the Offer and Use of Proceeds

Not applicable.

Item 3D: Risk Factors

The key risks relating to our business and industry are included below. Additional risks of which we are presently not aware or that we currently deem immaterial may also impair our business.

Sales to a small number of customers represent a substantial portion of our revenues. The loss of any major customers could significantly harm our financial condition.

We derive a substantial portion of our revenues from a relatively small number of customers. Our top customers by revenue are Network Appliance and Seagate Technology. In our 2006 fiscal year, sales to these customers accounted for 46% and 28% of our revenues, respectively. In our 2005 fiscal year these customers accounted for 48% and 30% of our revenues, respectively. It is likely that a small number of customers will continue to account for a substantial portion of our revenues in the future. If we were to lose one of our major customers, experience any material reduction in orders from any of these customers or experience a deterioration in our relationships with any of these customers, our financial condition could be significantly harmed.

In 2005, Dot Hill Systems Corp a competitor of Xyratex, announced that they had been awarded a program by Network Appliance for the development of a new storage product. In 2006, Xyratex provided nearly all the storage system enclosure requirements of the Network Appliance product lines. Any large penetration of Dot Hill into this account could adversely affect our growth in revenues and harm our financial condition.

In 2006, Seagate acquired Maxtor Corp, which was an emerging customer of Xyratex. Immediately following this major consolidation in the disk drive marketplace there was a market share realignment. This created significant volatility in demand for our disk drive production equipment. This increase in

volatility in the Storage Infrastructure marketplace is expected to continue into 2007. In addition we understand that Seagate intend to reutilize certain Maxtor equipment which is currently idle. This would create a reduction in demand until the surplus capacity is fully deployed. Also, if one of our major customers is acquired by one of its competitors that is not one of our customers our business with that major customer could reduce or cease altogether. The new parent company may impose a divergent strategy away from our existing technology base, potentially resulting in the loss of business to Xyratex.

Our customers operate in an industry that experiences frequent volatility. If any of our top customers were to suffer financial difficulties, whether as a result of downturns in the markets, loss of market share in which they operate or otherwise, our financial condition could be significantly harmed.

The markets in which we operate are cyclical and a reduction in customer demand in any particular financial period could significantly harm our financial condition.

Customer demand is cyclical in the technology industry in general, and the disk drive production equipment market in particular. One reason for the particular variability in demand for these products is that, for our customers, the decision to invest in new or upgraded production facilities is a strategic decision that involves a significant commitment of their financial resources. A customer s decision is dependent upon several factors, including its financial condition, the condition and obsolescence of its existing production facilities, the expected demand for its products and general confidence in its business. Our revenues are likely to continue to reflect the cyclical nature of the technology industry.

Demand for our disk drive production equipment products is also linked to developments in the disk drive market. The market for disk drives has historically experienced periods of production over-capacity which have in turn led to the deterioration of market prices for data storage products. Consolidation activity could impact the normal pattern of demand versus supply as the hard disk customers move business away from the consolidated entity to achieve an independent dual source strategy. Competitive activity usually increases during this period of market share realignment as each company tries to grow their share and often results in increased disk drive inventories in the channel. The confidence of our customers to invest in new disk drive production equipment does not usually recover until supplies of disk drives are reduced or new technologies are introduced. Future over-capacity and further consolidation in the disk drive market could result in a significant decrease in demand for our products, and this could significantly harm our financial condition.

Because original equipment manufacturers comprise a substantial portion of our customer base, we have limited control over the volume and pricing of our products, which could significantly harm our financial condition.

We sell our Networked Storage Solutions products primarily to original equipment manufacturers, or OEMs, and our Storage Infrastructure products directly to disk drive manufacturers. As a result, the quantity of products that we sell is significantly affected by our OEM customers volume requirements, over which we have little control. We are subject to continued pricing pressures from our customers, particularly our OEM customers. If these volume requirements decrease or pricing pressures increase, our financial condition could be significantly harmed.

Our operating results are subject to substantial quarterly and annual fluctuations, our period to period comparisons are not necessarily meaningful and we may not meet the expectations of public market analysts and investors.

Our revenues in any quarter are substantially dependent upon customer orders in that quarter. We attempt to project future orders based in part on estimates from our major customers. For this purpose, arrangements with major customers will usually include the estimated future volume requirements of that customer. Our customers estimated requirements are not always accurate and we therefore cannot predict our quarterly revenues with any degree of certainty.

Our typical pricing model is based on several variables (including overall volume of products ordered and the type and cost of components) which also makes it difficult for us to accurately predict future revenues. In addition, we regularly develop new products. Revenues from new products are difficult for us to predict accurately and are usually at a higher initial cost due to the low initial volumes. Any delay in the development of new products could further complicate revenue predictions and result in a reduction in our expected revenues.

Our quarterly operating results have fluctuated significantly in the past, as shown in the table below.

Quarter	Revenues (unaudited) (U.S. dollars in thousands)	Net Income (Loss) from Continuing Operations
First Quarter 2005	$ 142,523	$ 9,443
Second Quarter 2005	169,604	11,050
Third Quarter 2005	163,918	7,857
Fourth Quarter 2005	203,564	13,539
First Quarter 2006	190,517	6,437
Second Quarter 2006	288,882	24,576
Third Quarter 2006	263,138	17,811
Fourth Quarter 2006	$ 241,096	$ 9,354

In addition, we may derive a significant portion of our revenues in each quarter from a small number of relatively large orders. If one or more of our major customers decides to defer a purchase order in any given quarter, this is likely to result in reduced total revenues for that quarter. Accordingly, comparisons of our quarterly results of operations or other period to period comparisons are not necessarily meaningful and should not be relied on as an indication of our future performance.

Our quarterly and annual revenues and results of operations may also fluctuate significantly if one or more of the risk factors identified in this Annual Report occurs and, depending upon the timing of that event, may have a disproportionate effect in any given quarter or year. In addition, it is possible that some future results of operations may be below the expectations of public market analysts and investors.

Our gross margins may vary based on the configuration of our products and the mix in a period.

We derive a significant proportion of our sales from the resale of disk drives as components of our storage systems and the market is highly competitive and subject to intense pricing pressures. Our sales of disk drives generate lower gross margins than other components of our storage systems. As a result if we sell systems with greater disk content our overall gross margins may be negatively affected.

Our gross margins have been and may continue to be affected by a variety of other factors, including:

- Mix in demand of storage systems containing Fibre Channel, SAS or SATA disk drives.
- New product introductions or product enhancements.
- Inventory valuation adjustments as a result of changes in demand forecasts or product defects as we transition our product.
- Additional freight, transportation and other one-time costs to expedite component purchases or move finished product between locations to satisfy short term changes in demand.
- Commoditization of hardware. As hardware becomes more commoditized our overall margins are affected. Without significant differentiation, services and software our margins will be impacted in the future.

Decreases in our gross margin from any of these factors could significantly harm our financial condition.

Our market is highly competitive and we may not be able to compete effectively.

We operate in markets that are highly competitive and subject to rapid change and that are significantly affected by new product introductions and other market activities of industry participants. We expect competition to persist and intensify in the future. Our principal sources of competition include:

- companies providing storage subsystems and components to OEMs, including Dot Hill Systems Corp., Sanmina-SCI trading as Newisys and LSI trading as Engenio Information Technologies Inc. Additionally we are starting to see more competition arise from larger suppliers, such as EMC and Hitachi, as the lines between enterprise storage and middle tier storage begin to blur. EMC and others are expanding down into our middle to low tier Networked Storage Solutions markets, where there is significant growth, and lower tier suppliers may also attempt to expand upwards to achieve better margins for their products;

- Electronic Manufacturing Services (EMS) companies may acquire the necessary skills and intellectual property to enter the Storage Systems marketplace. Sanmina-SCI Corp addresses our market through its subsidiary, Newisys after it completed the acquisition of certain assets from Adaptec Inc., a competitor to our storage systems business;

- in-house development efforts by existing and potential customers, particularly in the Storage Infrastructure market; and

- collaborations between in-house development teams and emerging technology companies.

In addition, we face potential competition from new entrants including our current technology suppliers.

Some of our current and potential competitors may have longer operating histories, lower operating costs, or greater financial, technical, marketing or other resources than we do and we cannot assure you that we will have the resources to compete successfully in the future. In addition, some of our competitors have the resources to enable them to adopt aggressive pricing policies to gain market share or to shift production to lower cost regions. If we are unable to compete successfully against our current and future competitors, we could experience profit margin reductions or loss of market share, which could significantly harm our financial condition.

Our competitors may consolidate or form alliances with each other in the future. The successful consolidation of two or more of our competitors could result in the combination of their resources and technological capabilities. This could result in a more formidable competitor with improved access to a wider customer base and improved economies of scale and could result in the loss by us of significant market share. In addition, any future consolidation between any of our competitors and any of our suppliers could result in increased costs for the supply of components from that supplier or the need to find an alternative source for the supply of those components. If we are not able to find an alternative supplier then our ability to manufacture our products at acceptable prices or to deliver our products on time could be impaired. Moreover, future consolidation between any of our competitors and any of our customers could result in a decrease in the volume of purchases from that customer or the loss of that customer altogether. Industry consolidation within the markets in which we operate could adversely affect our revenues and negatively impact our competitive position.

The success of our business depends on the continued high growth of the volume of digital information and the market for data communication networks. If this growth does not occur at the rate anticipated our business may be significantly harmed.

Virtually all of our products find application in data storage and in the establishment and operation of data communication networks. If the growth that we and others have forecasted in the data storage and data communication networking markets does not occur at the rate we expect, our business may be significantly harmed.

Claims by third parties that we infringe their intellectual property or that patents on which we rely are invalid could significantly harm our financial condition, and the enforcement of our intellectual property rights may be expensive and could divert valuable company resources.

We operate in an industry characterized by frequent disputes over intellectual property. Third parties have in the past asserted, and in the future may assert, patent, copyright, trademark and other intellectual property rights to technologies that are important to our business and make claims that our products and technologies infringe their intellectual property, which could result in infringement lawsuits being filed against us. Any claims, whether made directly against us or through the indemnification arrangements we often enter into with our customers, could result in costly litigation, divert the attention of our technical and management personnel from operating our business, cause product shipment delays, or prevent us from making or selling certain products. In addition, we cannot give assurances that we would prevail in any litigation related to infringement claims against us. Generally, our liability insurance does not cover claims of this type. Moreover, as a result of these sorts of claims, we could be required to enter into royalty or licensing agreements which, if available, may not be available on commercially reasonable terms. We expect that providers of storage products will increasingly be subject to infringement claims as the number of products and competitors increases.

We may also need to assert claims against others in the future to enforce our intellectual property rights, to protect our trade secrets, or to determine the validity and scope of the proprietary rights of others, and we cannot be sure that we would prevail in any future litigation. Any litigation of this nature, whether or not determined in our favor or settled by us, would be costly and could divert valuable company resources. The enforcement by third parties of their intellectual property rights against us or the failure to successfully protect our intellectual property rights could significantly harm our financial condition.

Some of our products contain open source software, and any failure to comply with the terms of one or more of these open source licenses could negatively affect our business.

Some of our products are distributed with software licensed by its authors or other third parties under so-called open source licenses, which may include, for example, the GNU General Public License, or GPL, the GNU Lesser General Public License, or LGPL, the Mozilla Public License, the BSD License, and the Apache License. Some of these licenses may require as a condition of the license that we make available source code for modifications or derivative works we create based upon, incorporating, or using the open source software, that we provide notices with our products, and/or that we license such modifications or derivative works under the terms of a particular open source license or other license granting third parties certain rights of further use. If an author or other third party that distributes such open source software were to allege that we had not complied with the conditions of one or more of those open source licenses, we could be required to incur legal expenses in defending against such allegations, and if our defenses were not successful we could be enjoined from distribution of the products that contained the open source software and required to either make the source code for the open source software available, to grant third parties certain rights of further use of our software, or to remove the open source software from our products, which could disrupt our distribution and sale of some of our products. In addition, if we combine our proprietary software with open source software in a certain manner, we could under some of the open source licenses be required to release the source code of our

proprietary software. If an author or other third party that distributes open source software were to obtain a judgment against us based on allegations that we had not complied with the terms of any such open source licenses, we could also be subject to liability for copyright infringement damages and breach of contract for our past distribution of such open source software.

The markets for our products are characterized by frequent technological innovation. If we do not successfully develop new products in a timely manner our future operating results and competitive position could be significantly harmed.

The markets for our products are characterized by rapid technological change, frequent new product introductions and technology enhancements, uncertain product life cycles and changes in customer demands. We cannot give assurances that the design of future products will be completed as scheduled, that we will not experience difficulties that delay or prevent successful development, introduction, marketing and licensing of new products, or that any new products that we may introduce will achieve market acceptance or commercial success. In addition, the introduction of products based on new technologies and new industry standards could render our existing products obsolete and unmarketable and could devalue our previous investment in research and development. If we do not successfully develop new products in a timely manner our future profitability and competitive position could be significantly harmed. As a result of rapid technological changes, we may have to exit markets in which we operate. If we cannot manage the impact of the disruption on our existing customer base, our financial condition could be harmed.

The markets for our products are also characterized by technological change driven in part by the adoption of new industry standards. These standards coordinate the natural competitive behavior within the technology spaces and provide mechanisms to ensure technology component interoperability can occur. If any of our markets or technology space become completely defined by such standards it would reduce any capability for differentiation or innovation and our affected products would revert to commodity status. This could lower the barriers to entry to our market away from our specialist research and development skills and enable entry for the general-purpose design skills found in some large EMS and Contract Electronic Manufacturing (CEM) companies. Commodity markets are driven by extremely low margins and very aggressive competitive pricing. If our market becomes more commoditized and we fail to deliver innovative value-added alternatives to our customers we will have great difficulty competing against the larger EMS and CEM companies and our financial condition could be harmed.

We are dependent on single source suppliers and limited source suppliers for certain key components.

Our manufacturing process depends on the availability and timely supply of components which meet our specifications and quality demands. Some of the components that we integrate into our own products are highly specialized and may only be available from a single source or a limited number of suppliers. In particular, we depend on Solectron Corporation as our sole source supplier for the provision of electronic circuit boards. Our reliance on Solectron reduces our control over the manufacturing process, exposing us to risks including reduced control over quality assurance, increased production costs and reduced product supply. If we fail to manage effectively our relationship with Solectron, or if Solectron experiences delays, disruptions, capacity constraints or quality control problems in their manufacturing operations, our ability to ship products to our customers could be impaired and our competitive position and reputation could be damaged. Moreover, if any of our suppliers were to cancel or materially change their commitments to us or fail to meet the quality or delivery requirements needed to satisfy customer demand for our products, we could lose time-sensitive orders, be unable to develop or sell some products cost-effectively or on a timely basis, if at all, and have significantly decreased revenues, margins and earnings, which would have a material adverse effect on our business. In addition, our suppliers may go out of business, be impacted by natural disasters or may cease production of components, and it can take a substantial period of time to

qualify a new supplier of components. Moreover, we obtain these components through purchase order arrangements and do not have long-term supply agreements in place with our suppliers.

We often aim to lead the market in new technology deployments and leverage unique technology from single source suppliers who are early adopters in the emerging market. Our options in supplier selection in these cases are limited and the supplier based technology may consequently be single sourced until wider adoption of the technology occurs. In such cases any technical issues in the supplier s technology may cause us to delay shipments of our new technology deployments and therefore harm our financial position.

We are heavily dependent on our proprietary technology and our competitors may gain access to this technology.

We depend heavily on our proprietary technology and rely on a combination of patent, copyright and trade secret laws to protect our intellectual property and expertise. We also attempt to protect our trade secrets and other proprietary information through confidentiality agreements with our customers, suppliers and employees and through other security measures. Despite these efforts, we cannot give assurances that others will not gain access to our trade secrets or that we can fully protect our intellectual property. In addition, effective trade secret protection may be unavailable or limited in certain countries in which we operate. Nor can we guarantee that our competitors will not independently develop comparable technologies. We cannot rely on our patents to provide us with any significant competitive advantage. Failure to protect our proprietary rights could significantly harm our financial condition.

Our products are complex and may contain defects that are detected only after deployment in complex networks and systems.

Our products are highly complex and are designed to form part of larger complex networks and systems. Defects in our products, or in the networks and systems of which they form a part, may directly or indirectly result in:

- increased costs and product delays until complex solution level interoperability issues are resolved;
- costs associated with the remediation of any problems attributable to our products;
- loss of or delays in revenues;
- loss of customers;
- failure to achieve market acceptance and loss of market share;
- increased service and warranty costs; and
- increased insurance costs.

Defects in our products could also result in legal actions by our customers for property damage, injury or death. Product liability claims could exceed the level of insurance coverage that we have obtained to cover defects in our products. Any significant uninsured claims could significantly harm our financial condition.

We may not be able to effectively manage our anticipated growth, the expansion of our operations or the implementation of our new Enterprise Resource Planning infrastructure.

We have experienced a period of strong growth which would lead us to believe that we must be capable of managing strong growth in the future. This has placed, and will continue to place, significant demands on our management, operational, engineering and financial resources. In particular, there is a risk that the need to manufacture increasing volumes of products in order to meet large orders may temporarily affect our ability to control quality in the production process and our ability to deliver products on time. Our ability to effectively manage growth and expansion will also require us to continue to

implement and improve our operational, financial and management information systems and research and development processes, to train and manage our employees and to continue to develop, maintain and expand our supplier and customer relationships. Any failure to manage this growth effectively could significantly harm our financial condition.

We believe we need to invest in a new Enterprise Resource Planning infrastructure throughout the company to sustain our strategic growth objectives. In 2006 we implemented SAP in a pilot location and plan to complete the implementation of SAP across the company by mid 2008. Moving our entire financial and enterprise control systems onto the new SAP system involves significant risks. This may affect our ability to provide accurate quarterly reporting, maintain adequate control over our business or maintain compliance with section 404 of the Sarbanes-Oxley Act in the future during the transition period. This could result in a loss of confidence in the business externally, adversely affecting some customer orders, shareholder and supplier confidence, and could significantly harm our financial condition.

Our future growth depends in part on our successfully identifying and executing acquisitions, joint ventures and strategic relationships.

Our growth strategy may involve acquisitions, strategic alliances or joint ventures. For example, in May 2005, we acquired the business of Oliver Design, Inc, a company located in Scotts Valley, California, which develops and sells precision cleaning process technology for use in the magnetic disk media drive production process. In September 2005, we completed the acquisition of nStor Technologies, Inc., a U.S. based developer and provider of data storage subsystems, primarily to OEMs. These transactions involve certain risks resulting from the difficulties of integrating employees, operations, technologies and products. We may incur significant acquisition, administrative and other costs in connection with these transactions, including costs related to the integration of acquired or restructured businesses. In order to successfully integrate acquired operations into our business we may be required to expend significant funds, incur debt or assume liabilities, any of which could negatively affect our operations. In addition, the successful integration of acquired operations may also require substantial attention from our senior management, which may limit the amount of time available to be devoted to the day-to-day operations of our business or the execution of our business strategy. There can be no assurances that any of the businesses we acquire can be successfully integrated or that they will perform well once integrated. Additionally, we may be required to record expenses for write-downs of goodwill or other intangible assets associated with our acquisitions.

We have a long and unpredictable sales cycle.

Our products are technically complex and we typically supply them in high quantities to a small number of customers. Many of our products are also tailored to meet the specific requirements of individual customers, and are often integrated by our customers into the systems and products that they sell. Factors that affect the length of our sales cycle include:

- the time required for testing and evaluating our products before they are deployed;
- the size of the deployment; and
- the degree of system configuration necessary to deploy our products.

As a result, our sales cycle may take up to 18 months, and the length of our sales cycle is frequently unpredictable. In addition, the emerging and evolving nature of the market for the products that we sell may lead prospective customers to postpone their purchasing decisions. We invest resources and incur costs during this cycle that may not be recovered if we do not successfully conclude sales. These factors lead to difficulty in matching revenues with expenses, and to increased expenditures which together may contribute to declines in our results of operations and our share price.

We operate in the United States, Asia and the United Kingdom and we cannot predict the impact that risks typically associated with conducting business internationally will have on our business.

We have operations in the United States, Asia and the United Kingdom, and we market and sell our products throughout the world. As a result, we are exposed to risks typically associated with conducting business internationally, many of which are beyond our control. These risks include:

- significant currency fluctuations between the U.S. dollar (in which our revenues are principally denominated) and the U.K. pound (in which certain of our costs are denominated);

- complexities of managing our operations in the United States, the United Kingdom and Malaysia;

- uncertainty owing to the overlap of different legal regimes, a possibly disadvantageous legal position due to the application of foreign law as well as problems in asserting contractual or other rights across international borders, for example, warranty claims against suppliers and claims for payment against customers;

- potentially adverse tax consequences, such as transfer pricing arrangements between the countries in which we operate or a deemed change in the tax residence of one or more of our subsidiaries;

- potential tariffs and other trade barriers;

- unexpected changes in regulatory requirements;

- the burden and expense of complying with the laws and regulations of various jurisdictions;

- the impact of a re-occurrence of an outbreak of severe acute respiratory syndrome, or SARS, or any other viral pandemic, such as the avian flu virus, on our employees;

- the impact of a natural disaster affecting a large geographical region, for example the Asian earthquake and resulting wide spread tsunami in 2004, could affect either supply lines, our ability to produce products internally or our customers ability to pay or purchase new products; and

- the world is experiencing sustained levels of unusual weather patterns in all geographies, which could deteriorate further in the future. As a global operation, we are affected by any adverse weather patterns that cause us to invest in extensive plant and machinery to protect our buildings and production operations across the globe or which adversely affect our ability to ship on time to customers, design product, receive material, or relocate out of a specific geography.

The occurrence of any of these events could significantly harm our financial condition.

We have experienced operating losses in the past and there can be no assurance that we will be profitable in the future. We do not currently anticipate paying any dividends on our common shares.

We recorded operating income of $60.3 million and $44.7 million in our 2006 and 2005 fiscal years respectively and operating losses of $129.5 million and $47.4 million in our 2004 and 2003 fiscal years, respectively. We expect to continue to incur significant product development, administrative and sales and marketing expenses as well as costs associated with potential future acquisitions. Thereafter we will need to generate significant revenues in order to maintain profitability. We cannot assure you that we can sustain or increase operating income on a quarterly or annual basis in the future. We currently intend to retain all available earnings generated by our operations to develop and grow our business and we do not currently anticipate paying any dividends on our common shares.

We are dependent upon hiring and retaining highly qualified management and technical personnel.

We operate in the storage and networking technology markets. Our key management and technical staff are located in the United Kingdom, United States of America, and in Malaysia. Particularly in the United Kingdom and California there is strong competition for the highly qualified management and technical personnel with experience in our markets that we need to run our business and to develop new

technologies and products. In California, in particular, the rate of turnover of key personnel in our markets is high. Our future success depends in part on our continued ability to hire and retain well-qualified technical personnel. We also rely heavily on our senior management and their ability to maintain relationships with our key customers. Many of our senior managers would be difficult to replace. In addition, we do not maintain key-person life insurance on any member of our senior management, with the exception of our Chief Executive Officer. The loss of any of our key management or technical personnel could significantly harm our financial condition.

We may incur expenses related to obsolescence or devaluation of unsold inventory, or to reserves necessary to protect us against future write-offs of unsold inventory.

Failure by us to accurately estimate product demand could cause us to incur expenses related to obsolescence or devaluation of unsold inventory. Due to the nature of our sales arrangements and supply and production arrangements, we may carry a significant amount of unsold inventory. As part of our internal controls, we have comprehensive inventory controls which include management approval for significant inventory purchases and monthly reviews of inventory levels and obsolescence. Historically our costs related to obsolescence have been less than 0.5% of revenues. However, if we fail to accurately estimate product demand, this inventory may lose value or become obsolete before it is sold. This may require us to increase our reserves for obsolete inventory which could significantly harm our financial condition.

If our Malaysian subsidiary ceases to receive favorable tax treatment by the Malaysian government we may be subject to tax liability that could significantly harm our financial condition.

A large proportion of our revenues are recorded by our Malaysian subsidiary, which benefits from tax incentives granted by the Malaysian government, currently in force until May 2012. Our favorable tax treatment in Malaysia is dependent upon meeting certain requirements set out by the Malaysian authorities and demonstrating to both the Malaysian and the U.K. tax authorities that transactions between the relevant parties take place on an arm s-length basis. The loss of these tax benefits could increase our tax liabilities for past, current and future years, which could significantly harm our financial condition.

Geopolitical military conditions, including terrorist attacks and other acts of war, may materially and adversely affect the markets on which our common shares trade, the markets in which we operate, our operations and our financial condition.

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 customers and suppliers. 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 affect on our business and the trading price of our common shares.

We could incur substantial costs, including clean-up costs, fines and civil or criminal sanctions, as a result of violations of or liabilities under environmental laws.

Our operations inside and outside the United States are subject to laws and regulations relating to the protection of the environment, including those governing the discharge of pollutants into the air and water, the management and disposal of hazardous substances and wastes and the clean-up of contaminated sites. Certain of our operations involve the use of substances regulated under various federal, state and international environmental laws. It is our policy to apply strict standards for environmental protection to sites inside and outside the United States, even if not subject to regulations imposed by local governments. We could also incur substantial costs, including clean-up costs, fines and civil or criminal sanctions,

third-party property damage or personal injury claims if we were to violate or become liable under environmental laws or become non-compliant with environmental permits required at our facilities.

The European Parliament has enacted the Restriction on Use of Hazardous Substances Directive, or RoHS Directive, which restricts the sale of new electrical and electronic equipment containing certain hazardous substances, including lead, which is currently used in some of the products we manufacture. We are working to modify our manufacturing processes to eliminate these hazardous materials from our products and based on information available to us we have complied with the RoHS directive since the new restrictions came into force on July 1, 2006. The costs associated with continued compliance may negatively impact our results of operations and competitive position. We are also working with our suppliers to redesign or reformulate their components containing the hazardous substances to reduce or eliminate these materials from our products. However, if we do not comply with this Directive in the future, we may suffer a loss of revenue, be unable to sell in certain markets or countries and suffer competitive disadvantage.

The European Parliament has enacted the Waste Electrical and Electronic Equipment Directive, or WEEE Directive, which makes producers of electrical and electronic equipment financially responsible for specified collection, recycling, treatment and disposal of past and future covered products. We may incur financial responsibility for the collection, recycling, treatment or disposal of products covered under the WEEE Directive. Because the EU member states have not fully implemented the WEEE Directive, the nature and extent of the costs to comply and fees or penalties associated with non-compliance are unknown at this time. Costs to comply with the WEEE Directive and similar future legislation, if applicable, may also include legal and regulatory costs and insurance costs. We may also be required to take reserves for costs associated with compliance with these regulations.

Similar laws and regulations have been or may be enacted in other regions including the United States, China and Japan. These new restrictions may expand the list of banned hazardous substances or reduce the level of acceptable concentrations of other materials in our products. Although we do not anticipate any material adverse effects based on the nature of our operations and the effect of such laws, there is no assurance that such existing or future laws will not have a material adverse effect on our business.

Customers and potential customers, particularly in Japan, are requiring compliance with environmental controls more stringent than those required by European legislation. These may be nationally driven or company driven, as leading players in an industry take specific unilateral initiatives in pursuit of a corporate environmental strategy. For example, in Japan some of our potential customers have developed their own environmental standards which include amongst other things restrictions on the type of insulation surrounding copper wire and cables.

We will endeavor to comply with these environmental controls but any failure to keep up may harm our ability to work with certain customers or markets.

We may identify weaknesses and/or deficiencies with our controls over financial reporting when evaluating these controls for compliance with section 404 of the Sarbanes-Oxley Act.

We have recently completed our evaluation of our internal controls over financial reporting as required by Section 404 of the Sarbanes-Oxley Act of 2002. Although our assessment, testing, and evaluation resulted in our conclusion that as of November 30, 2006, our internal controls over financial reporting were effective, we cannot predict the outcome of our testing in future periods. In addition, our Independent Registered Public Accounting Firm will also be required to report on the effectiveness of these controls in our 2007 fiscal year. If our internal controls are ineffective in future periods, our business and reputation could be harmed. We may incur additional expenses and commitment of management s time in connection with further evaluations, either of which could materially increase our operating expenses and accordingly reduce our net income.

In our 2007 and 2008 fiscal years we are planning to replace our Enterprise Resource Planning system which will have a significant impact on our financial reporting process. The resulting changes in long-established processes may increase the risk of new deficiencies in controls over financial reporting arising. We can give no assurances that any such deficiencies identified may not be significant deficiencies or material weaknesses that may have an adverse effect on our business financial condition.

Changes in securities laws and regulations have increased and may continue to increase our costs.

Changes in the laws and regulations affecting public companies, including the provisions of the Sarbanes-Oxley Act of 2002 and rules promulgated by the Securities and Exchange Commission, have increased and may continue to increase our expenses as we evaluate the implications of these rules and devote resources to respond to their requirements. In particular, we are incurring additional administrative expense to comply with Section 404 of the Sarbanes-Oxley Act, which requires management to report on, and for our 2007 fiscal year our Independent Registered Public Accounting Firm to report on, our internal control over financial reporting.

In addition, The NASDAQ Stock Market LLC, on which our shares are listed, has also adopted comprehensive rules and regulations relating to corporate governance. These laws, rules and regulations have increased and will continue to increase the scope, complexity and cost of our corporate governance, reporting and disclosure practices. We also expect these developments to make it more difficult and more expensive for us to obtain director and officer liability insurance in the future, and we may be required to accept reduced coverage or incur substantially higher costs to obtain coverage. Further, our board members, Chief Executive Officer and Chief Financial Officer could face an increased risk of personal liability in connection with the performance of their duties. As a result, we may have difficultly attracting and retaining qualified board members and executive officers, which would adversely affect our business.

If securities or industry analysts do not publish research or reports about our business, or if they change their recommendations regarding our stock adversely, our stock price and trading volume could decline.

The trading market for our common stock will be influenced by the research and reports that industry or securities analysts publish about us or our business. If one or more of the analysts who cover us downgrade our stock, our stock price would likely decline. If one or more of these analysts cease coverage of our company or fail to regularly publish reports on us, we could lose visibility in the financial markets, which in turn could cause our stock price or trading volume to decline.

Fluctuations in the price and volume of shares of technology companies could result in the volatility of our share price.

We are a storage and networking technology company. Stock markets generally have recently experienced extensive price and volume fluctuations, and the market prices of securities of technology companies in particular have experienced fluctuations that often have been unrelated or disproportionate to the operating results of those companies. These market fluctuations could result in extreme volatility in the price of our common shares. You should also be aware that price volatility may be more pronounced if the trading volume of our common shares is low.

Our principal shareholders and management own a significant percentage of our company and will be able to exercise significant influence over our company, and their interests may differ from those of our other shareholders.

Our executive officers and directors and principal shareholders and their affiliated entities together control approximately 37.5% of our issued and outstanding common shares. Accordingly, these shareholders, if they act together, have significant influence over our affairs. They may exercise this influence by voting at a meeting of the shareholders in a manner that advances their best interests and not necessarily those of other shareholders. This concentration of ownership also could have the effect of

delaying or preventing a change in control of our company or otherwise discouraging a potential acquirer from attempting to obtain control of us.

We are incorporated in Bermuda and, as a result, it may not be possible for shareholders to enforce civil liability provisions of the securities laws of the United States.

We are incorporated under the laws of Bermuda and a substantial portion of our assets and the majority of our executive officers and directors are located outside the United States. As a result, it may not be possible for the holders of our common shares to effect service of process upon us or our directors or officers within the United States or to enforce against us or our directors or officers in the United States court judgments based on the civil liability provisions of the securities laws of the United States. In addition, there is significant doubt as to whether the courts of Bermuda would recognize or enforce judgments of United States courts obtained against us or our directors or officers based on the civil liability provisions of the securities laws of the United States or any state thereof. Consequently, there is also significant doubt as to whether the courts of Bermuda would be prepared to entertain an original action in Bermuda based on those laws. We have been advised by our United States and Bermuda legal advisors that the United States and Bermuda do not currently have a treaty providing for the reciprocal recognition and enforcement of judgments in civil and commercial matters. Therefore, a final judgment for the payment of money rendered by any federal or state court in the United States based on civil liability, whether or not based on United States federal or state securities laws, would not be automatically enforceable in Bermuda.

Bermuda law differs from the laws in effect in the United States and may afford less protection to shareholders.

Holders of our common shares may have more difficulty in protecting their interests than would shareholders of a corporation incorporated in a jurisdiction of the United States. We are a Bermuda company and, accordingly, we are governed by the Companies Act 1981 of Bermuda, as amended. The Companies Act differs in certain material respects from laws generally applicable to United States corporations and shareholders, including:

- *Interested director transactions*: Under the terms of our bye-laws, any director, or any director s firm, partner or any company with whom any director is associated, may act in a professional capacity for the company, other than as auditor, and such director or such director s firm, partner or such company is entitled to remuneration for professional services. Our bye-laws require that a director who is directly or indirectly interested in a proposed contract or arrangement declare the nature of that interest as required by the Companies Act 1981, but after such a declaration, unless disqualified by the Chairman of the relevant board meeting, such director may vote in respect of any contract or proposed contract or arrangement in which he or she is interested and may be counted in the quorum at such meeting. United States companies are generally required to obtain the approval of a majority of disinterested directors or the approval of shareholders before entering into any transaction or arrangement in which any of their directors has an interest, unless the transaction or arrangement is fair to the company at the time it is authorized by the company s board of directors or shareholders.

- *Business combinations with interested shareholders*: United States companies in general may not enter into business combinations with interested shareholders, namely certain large shareholders and affiliates, unless the business combination has been approved by the board of directors in advance or by a supermajority of shareholders or the business combination meets specified conditions. Under Bermuda law, and under our bye-laws, our board of directors may approve certain business combinations with interested shareholders without the need for a shareholder vote although certain business combinations, such as amalgamations, an arrangement under Bermuda

law whereby two corporate entities combine and continue as a combined corporate entity but where neither of the original corporate entities cease to exist, usually require shareholder approval.

- *Shareholder suits*: The circumstances in which a shareholder may bring a derivative action in Bermuda are significantly more limited than in the United States. In general, under Bermuda law, derivative actions are permitted only when the act complained of is alleged to be beyond the corporate power of the company, is illegal or would result in the violation of the company s memorandum of association or bye-laws. In addition, Bermuda courts would consider permitting a derivative action for acts that are alleged to constitute a fraud against the minority shareholders or, for instance, acts that require the approval of a greater percentage of the company s shareholders than those who actually approved them.

- *Limitations on directors liability*: Our bye-laws provide that each shareholder agrees to waive any claim or right of action he or she may have, whether individually or in the right of the company, against any director, except with respect to claims or rights of action arising out of the fraud or dishonesty of a director. This waiver may have the effect of barring certain claims against directors arising under U.S. federal securities laws. In general, United States companies may limit the personal liability of their directors as long as they acted in good faith and without knowing violation of law.

We have provisions in our bye-laws that may discourage a change of control.

Our bye-laws contain provisions that could make it more difficult for a third party to acquire us without the consent of our board of directors. These provisions include:

- a classified board of directors with staggered three-year terms;

- the ability of our board of directors to determine the rights, preferences and privileges of our preference shares and to issue the preference shares without shareholder approval; and

- the need for an affirmative vote of the holders of not less than 66% of our voting shares for certain business combination transactions which have not been approved by our board of directors.

These provisions could make it more difficult for a third party to acquire us, even if the third party s offer may be considered beneficial by many shareholders. As a result, shareholders may be limited in their ability to obtain a premium for their shares.

ITEM 4: INFORMATION ON THE COMPANY

Item 4a: History and Development

Xyratex Ltd is a limited liability company incorporated under the laws of Bermuda. Xyratex Ltd was incorporated on April 10, 2002 and is registered with the Registrar of Companies in Bermuda under registration number EC 31989. As a Bermuda company we are governed by the Companies Act 1981 of Bermuda. Our registered office is located at Clarendon House, Church Street, Hamilton, Bermuda. Our agent for service of process in the United States is Chris Sharman, 2031 Concourse Drive, San Jose, California 95131-1727, USA (telephone: (408) 894 0800).

Xyratex Ltd became the parent company of our business immediately prior to the closing of our initial public offering on June 29, 2004, in order to facilitate the listing of our common shares on The NASDAQ Stock Market LLC. Xyratex Ltd became our parent company by way of a scheme of arrangement under Section 425 of the Companies Act 1985 of the United Kingdom, pursuant to which the issued shares in Xyratex Group Limited, the parent company of our business prior to the time of our initial public offering, were cancelled in consideration of (i) the issue of common shares of Xyratex Ltd to the former shareholders of Xyratex Group Limited and (ii) the issue of new shares in Xyratex Group Limited to Xyratex Ltd.

Our business began as part of IBM in 1966. We conducted our business as a manufacturing and development operation until December 1994, at which time we separated from IBM in a management buy-out. During our period as part of IBM, we built up significant expertise in both data storage and networking technologies and their related markets.

Following our management buy-out, we restructured our business through acquisitions, disposals, and organic investments to form our core global storage and network technology business. Through divestitures we have realized approximately $200 million of proceeds, of which approximately $120 million has been returned to shareholders. These divestitures have also enabled us to make significant investments in research and development focused on building our core competencies of designing and delivering advanced storage and networking technologies and products.

In September 2003, we successfully completed a private equity transaction with HgCapital, a European private equity firm, pursuant to which HgCapital became one of our major shareholders. The transaction allowed several of our founders and our original venture capital partner to retire and certain of our shareholders to realize their investments by selling their shares.

In February 2004, we acquired the business of ZT Automation LLC, a company located in Fremont, California, which develops and sells magnetic disk media handling automation technology for use in the disk drive production process.

In September 2004 we acquired the intellectual property of Beyond3, a developer of advanced optical inspection systems based in San Jose, California.

In May 2005, we acquired the business of Oliver Design, Inc, a company located in Scotts Valley, California, which develops and sells precision cleaning process technology for use in the magnetic disk media drive production process.

In September 2005, we acquired nStor Technologies, Inc., a company which was headquartered in Carlsbad, California and listed on the American Stock Exchange. The company was a developer and provider of data storage subsystems, primarily to OEMs and owned strategic intellectual property in RAID and Serial Attached SCSI (SAS) storage technologies.

In September 2006, we acquired the business of Jastam Trading Co. Ltd., a company located in Tokyo, Japan. Jastam was a full service broker for equipment suppliers to high technology customers in Japan. This acquisition establishes a Japanese customer support infrastructure for both of our divisions. It will also expand our presence in the strategic Japanese marketplace (See Item 5: Acquisitions and Disposals).

In January 2007 we acquired key assets from Ario Data Networks Inc, which included intellectual property, capital equipment and skilled resources. The acquisition of these assets enabled us to expand our capability in software feature development and obtain key code modules that will add value to our existing and future products in Networked Storage Solutions (See Item 5: Acquisitions and Disposals).

Item 4b: Business Overview

Business Overview

We are a leading provider of modular enterprise-class data storage solutions and storage process technology. We design, develop and manufacture enabling technology that provides our customers with data storage products to support high-performance storage and data communication networks. We operate in two business segments: Storage and Network Systems and Storage Infrastructure (SI). In January 2007, the Storage and Network Systems segment changed its name to Networked Storage Solutions or NSS. We believe this change better aligns with our customers needs, the changing market towards networked environments and the market s view of our role as a technology solution provider. Our Networked Storage Solutions products provide modular, highly scalable, high-speed, high-density, reliable and flexible data storage. Our storage subsystems support a range of high-speed communication technologies and cost and performance specifications. Our modular subsystem architecture allows us to support many segments

within the networked storage market by enabling different specifications of storage subsystem designs to be created from a standard set of interlocking technology modules. Using data published by International Data Corporation, or IDC, an independent research company, on the number of terabytes shipped in 2005 and forecast for 2006, we estimate that we are responsible for approximately 14% of the world wide external storage systems petabyte shipments through our OEM customer base. This represents 399.4 petabytes in 2006, or over a petabyte shipment every day. A terabyte and a petabyte are units of measurement equal to one thousand gigabytes and one million gigabytes of information, respectively. Our Storage Infrastructure products include disk drive production test systems, process automation, servo track writers and disk cleaning systems. We believe that over 55% of all 3.5 inch disk drives shipped and over 20% of all 2.5 inch disk drives shipped worldwide are processed utilizing either our servo track writer or final test and qualification systems and we estimate that our Storage Infrastructure revenues account for approximately 15% of the capital spend within the annual capital budget of the disk drive industry. We have increased our revenues from $333.7 million in our 2003 fiscal year to $983.6 million in our 2006 fiscal year.

We have over 20 years of experience in research and development relating to disk drives, storage systems and high-speed communication protocols. This experience has enabled us to establish long-term, strategic relationships with our customers. We believe we have been first to market with several data storage system and test equipment products that complement our customers core competencies and objectives. For example, we were first to market with an automated test process solution for the disk drive manufacturing industry and first-to-market with the introduction of a switch to replace the traditional Fibre Channel (FC) loop architecture in a storage subsystem. We were also first to demonstrate Serial Attached SCSI, or SAS, storage systems with SAS host connection through SAS expander technology in 2004. In 2006, following the successful integration of nStor technology we began shipments in volume of captive RAID technology and were first to volume shipment of mixed SAS/SATA storage systems. In 2005 we announced a number of significant patent filings in the areas of optical backplane interconnect and revolutionary congestion management techniques required in multi-stage switching networks. Our storage subsystem and test and process equipment products enable our customers to improve asset utilization, reduce capital costs and better focus on their value-added objectives.

We sell our Networked Storage Solutions products primarily to original equipment manufacturers or OEMs, and our Storage Infrastructure products directly to disk drive manufacturers and their component suppliers. We have manufacturing, research and development and sales operations in the United States, Asia and Europe. We form long-term strategic relationships with our customers, which include Network Appliance, Seagate Technology and Western Digital. We enter into joint development projects with our key customers and suppliers in order to research and introduce new technologies and products. As of November 30, 2006, we had over 150 customers.

We believe we derive advantages from the technology and skill synergies and requirements across our Networked Storage Solutions and Storage Infrastructure business segments. Both segments require the integration of many types of high-speed disk drive technologies into a range of high-density, high-availability, scalable solutions.

Industry Overview

The last decade has seen a dramatic increase in the volume of data that is being captured, processed, stored and manipulated as digital information. This information is generated from many sources, including critical business applications, e-mail communications, the Internet and multimedia applications, which have collectively fueled an increase in demand for data storage capacity. Additionally, regulatory requirements and company policies requiring data preservation are expanding the use of storage resources in the enterprise. Businesses are now increasingly focusing on the issues surrounding increasing power consumption and thermal management within the enterprise to maintain compliance with emerging environmental legislation and reduce energy costs. We also continue to see a trend towards vendor

consolidation and a growing emphasis on data security. This increased storage requirement and data management complexity lead us to believe that a growing opportunity for outsourced data service offerings is emerging within the data storage and IT marketplace. According to IDC, in a report issued in May of 2006, worldwide IT storage revenues will continue to experience significant revenue growth. They projected revenues from all storage hardware, software and services, within the information technology or IT sector, to grow from $71 billion in 2006 to $82 billion in 2009. Terabytes shipments of all types of Enterprise Storage were also expected to increase at a compound annual growth rate of 56% until 2009.

Digital information storage is at the very center of the emerging compliance challenge in Healthcare, Life sciences, Financial Services and Government. Also, there has been a significant increase in digital information capture and access in overnight back up, large scale video content delivery and video archive applications. All these applications have historically been serviced using low cost magnetic tape technology. However, with the emergence of low cost capacity optimized disk drive technology these applications have moved towards higher performing disk drive solutions. According to IDC in a mid 2006 update report, the revenue for storage systems containing capacity optimized disk drive technology will grow from $1.6 billion in 2004 to $8.6 billion in 2010, representing a compound annual growth rate of 39%.

In addition to the rapid growth of data, enterprises face the challenge of managing the accessibility, prioritization and protection of data in a cost-efficient manner. The realization that not all data is of equal value is driving a proliferation of storage and networking technologies developed to address different data management requirements. These technologies include:

- *High-Speed Network Interface Connections to Hosts or Servers:* Storage Area Networks, or SANs, are moving from a legacy base of one gigabit and two gigabit Fibre Channel to four gigabit and eight gigabit Fibre Channel. The convergence of networking and storage technology is continuing, offering additional internet protocol, or IP, storage options, such as 10 Gigabit Ethernet and iSCSI for the host connections. Gigabit Ethernet is also widely deployed within the Network Attached Storage, or NAS market and we believe will follow the IP storage roadmaps.

- *High-Speed Connections from Remote Storage Controllers to Storage Subsystems:* These connections are following the enterprise disk drive connection roadmap and we believe will move to higher speeds and new interfaces, such as four gigabit Fibre Channel and three gigabit SAS.

- *High-Speed Disk Drive Interface Connections:* Disk drives are maintaining the historic trend of delivering ever faster connections speeds and new interfaces, such as four gigabit Fibre Channel and three gigabit SAS and Serial ATA, or SATA.

A proliferation of technologies has emerged to address the complex requirements of network storage. These changes have led to an increase in technology outsourcing by leading OEMs. This enables them to provide a broader range of tailored networked storage solutions while maintaining a focus on their core technologies.

New digital storage applications that enable the electronic distribution of media-rich content, such as digital music and video, in the home or as mobile accessories are fueling a rapid increase in the use of disk drive technologies to manage increased consumer driven storage demand. Non-PC applications of disk drives in the consumer electronics segments, are projected to grow in volume from 62.6 million in 2005 to 221 million in 2010, at a compound annual growth rate of 28.7% according to TrendFocus*, an independent research group. They also state that traditional uses of disk drives in the PC market space will continue to show opportunities for longer term growth with volumes projected to grow at a compound annual growth rate of 14.2% and revenues at a more modest 4.6% between 2005 and 2010.

* TrendFocus Information Services Storage Demand Analysis Service 2006 Annual Report , dated March 2006.

Networked Storage Solutions Market

According to IDC, worldwide external disk storage systems shipments in 2005 were 2,055 petabytes with shipments expected to reach 16,085 petabytes in 2010, representing a compound annual growth rate of 50.9%. The Small Medium Business (SMB) and Small Medium Enterprise (SME) make up the middle to low tier market opportunity. We have characterized this middle to low tier market as made up of companies which have less than 1,000 employees, approximately 5-25 terabytes of storage and 2, 4 and 8-way servers. We also believe that SME/SMB companies typically buy Storage solutions in price bands between $5k and $50k. This would correlate with price bands 2-4 in IDC s reported market segmentation and, using their data, we estimate the market size to be growing from $6.271 billion in 2006 to $10.326 billion in 2010 at a compound annual growth rate of 13.3%. We believe the demand for low cost, easy to use and enterprise-class feature and function continues to drive requirements within this space. In particular we believe significant growth may occur in the following application areas:

- Video Video on Demand, IP-TV, Film Post Production, Broadcast News Editing, Local Affiliate Commercial Insertion and Production
- Surveillance CCTV Recording (Prison, University), Corporate Network Monitoring, National Security Monitoring
- Vaulting Personal Photos, Tax Data, Consumer Backup
- Healthcare Digital X-Ray, CAT / MRI / PET Scanning

Fibre Channel (FC) continues to dominate as an interconnect technology in the enterprise storage market providing both high performance and long distance reach capability. SAS as a connectivity option, while offering significant promise, is still positioned as an early adopter technology and with its distance limitations is seen more as a SCSI replacement within the data center rather than a FC replacement.

Flexibility in drive types continues to be a requirement from customers and low cost high density SATA disk drives continue to show strong shipments in the market. Whilst this technology has proliferated as a low cost alternative, users have discovered that it is not a one size fits all solution and tiered storage architectures and policies are being deployed to address this. The reliability characteristics of high density SATA disk drives can cause major challenges and RAID 6 and other data protection schemes have become prevalent. These are key requirements of any high reliability system that needs to also provide continuous access to data. These features, while once considered value-add and optional, have become a standard for doing business. Other features are also emerging around the areas of power management. MAID (Massive Arrays of Idle Disks), a method of powering down the disk when not in use to conserve power is one approach to reducing power consumption.

The increased complexity caused by the proliferation of new technology and applications makes it difficult for information technology professionals to manage data, make data available to users, store data

reliably, and control all of the costs related to data storage. Networked data storage, including SANs and NAS, provide solutions to these data management issues by combining the benefits of data storage and networking technologies. A SAN connects multiple computer servers to a shared pool of storage resources using a dedicated high-performance network. A NAS system is an external storage system that is directly attached to a Local Area Network, or LAN, which allows all computer terminals on the LAN to have access to the data stored on that external disk storage system. Networked storage offers numerous benefits, including the ability to share data across an organization using different computing systems, simplified management through centralized administration of multiple storage devices, and scalability by allowing the number of storage devices on a network to be increased without interrupting data access.

The market for Fabric SAN attached Storage Systems is comprised of the Fibre Channel & iSCSI technology sub markets. IDC forecast that disk storage systems connecting to SANs through iSCSI

protocol will grow from less than $296 million in 2005 to $4.82 billion in 2010, representing a compound annual growth rate of 74.8% during the period. Using data provided by IDC we estimate that the market for Fabric SAN attached Storage Systems, will grow from $9.35 billion in 2005 to $15.88 billion by 2010, representing a compound annual growth rate of 11.2%. IDC also project the NAS market to grow from $2.22 billion in 2005 to $4.36 billion in 2009, representing a compound annual growth rate of 14.4%. These two network storage market segments are gaining market share within the overall external storage systems market, which is projected to grow from $17.51 billion dollars in 2005 to $23.19 billion in 2010, representing a compound annual growth rate of 5.84%. The combined market share of NAS and Fabric SAN was 66.1% of the external storage systems market in 2005 and is estimated to grow to 87.3% in 2010, at the expense of the Direct Attached Storage (DAS) legacy technology base.

RAID storage systems have become the prevailing technology for businesses where data availability is of critical importance, due to their high levels of performance and reliability. RAID storage subsystems consist of multiple disk drives together with a controller device that manages access to data stored on the disk drives. The controller manages access to the data so that if a disk drive fails, other disk drives in the RAID subsystem can be used to recover data that was lost from the affected disk drive. Historically, we have addressed this need by either integrating our storage enclosures with either our customer s storage controller or specialist third party controller technology. The adoption rate of RAID enabled data protection strategies has been less marked in the sub-segments serviced by SME and SMB sector. We typically characterize these sub segments as having external storage solution price points below $50,000. Using data from IDC we can see a growth in adoption from 80.9% in 2005 to approximately 93.3% in 2010.

We design, develop and manufacture storage subsystems that support a range of modular, high-speed communication technologies and performance specifications. Our modular design approach enables us to tailor our storage subsystems to meet the specific price and performance objectives of our customers. As storage and networking protocols continue to proliferate, we believe the strategic importance of our modular storage subsystems architecture will increase and we already have SAS, SATA and FC within our portfolio of products. We have been a market mover in the SAS space, both as an interconnect technology and as an implementer of tiered storage (i.e., mixing SAS and SATA drives) within the same enclosure. With our superior leadership in power, drive packaging, enclosure cooling and plans of advanced power management, we believe we are well positioned to leverage the growing trend towards energy. We believe our high density storage enclosures are recognized as best of class in the industry and enable us to take advantage of the emerging demand for bulk storage applications. The early identification of the increased adoption of low cost RAID technology by SME s was one of the prime drivers behind our acquisition of the nStor RAID technology in September 2005. We believe we are now well positioned to address the affordable RAID controller market growth opportunity.

Storage Infrastructure Market

Hard disk drive sales in 2005, in terms of unit shipments, grew at a rate of 24.9%, to over 381 million, according to TrendFocus Information Services. Their Storage Demand Analysis Service 2006 annual report forecast the disk drive industry to grow at 14.4% compounded annual rate (in unit terms) through 2010, approaching 750 million units by that time. Consumer-driven devices such as personal video recorders (PVRs), MP3 audio devices (e.g., iPod), game consoles, multi-function printers, automobile intelligence systems (AIS), digital still cameras (DSC), and a host of other new digital products are fueling a revolution in the hard disk drive (HDD) industry. These non-PC applications of disk drives are projected to grow in revenue from $4.916 billion in 2005 to $11.529 billion in 2010, at a compound annual growth rate of 18.6% according to the same report. We believe that, in order to maintain and grow disk drive output, manufacturers will need to increasingly invest in disk drive automation and process test equipment. This market is largely driven by a combination of the growth in the areal density of disk drives (as measured by data bits per square inch), disk drive unit shipments, disk drive capacity and the emergence of new interface protocols and form factors.

Based on the referenced report by TrendFocus, it is also expected that the 3.5 inch form factor which was the most popular in 2005, would continue to dominate throughout the forecast period. This form factor is currently the de facto standard in virtually all desktop and PVR solutions, and is also standard in a majority of all enterprise shipments. However, TrendFocus reported that 2.5 inch drive shipments surged in 2005 due in large part to the global shift towards acceptance of notebook solutions. They stated that 2.5 inch solutions also gained momentum into consumer electronics products, with shipments being focused initially on the AIS markets and on multi-function printer markets. Microsoft also shifted HDD form factors from 3.5 inch for the original Xbox, to 2.5 inch for the Xbox 360. This drove 2.5 inch demand in 2005 and is likely to continue to do so in the coming years. 2.5 inch solutions are also seeing increased interest from both enterprise and desktop products, although transition and acceptance has been much slower than originally anticipated. Using data from the referenced report we estimate that the 2.5 inch form factor will grow from 21.9% of drive volumes in 2005 to 34.4% market share in 2010.

The emergence in 2005 of perpendicular recording techniques within disk drives is a significant market dynamic and we estimate that it will be very difficult to achieve over 160 gigabyte per disk without it being actively deployed. Based on a Rigid Media & Substrate Information Service report from TrendFocus we believe that the areal density requirement for 3.5 inch drives will grow from 160 gigabytes per disk in 2006 to 640 gigabytes per disk in 2010. Perpendicular recording allows the magnetic circuit to flow perpendicularly through the layers of the disk rather than horizontally through the upper surface layers. This allows more magnetic material to be deployed per bit whilst simultaneously reducing the footprint of each individual bit on the disc s surface dramatically increasing the number of bits per square inch. We believe that this increase in bits per inch also increases the sensitivity of the magnetic media process to contamination as smaller defects are capable of affecting the magnetic performance of the disks. We believe that this should result in increased investment cycles in precision cleaning equipment and automated optical inspection techniques.

Using data from the TrendFocus report, dated March 2006 (Storage Demand Analysis System 2006 Annual Report) it is expected that the demand for large capacity drives, greater than 300 Gigabytes, will increase in volume from 9.61 million in 2005 to 420.5 million in 2010. In 2005 this volume was 3% of the marketplace and this share is projected to grow to 56% in 2010. We believe increased demand for large capacity disk drives contributes positively to our business as higher capacity drives require longer process test times on Xyratex process equipment and often have to use multiple hard disks per drive to achieve the high storage capacity.

Finished media shipments grew 33%, to 630.57 million, while substrate sales jumped 24%, to 755.27 million in 2005 according to the TrendFocus report, Rigid Media & Substrate Information Service published in March 2006. They projected that the compound annual growth rate for the next five years are expected to be 12.4% and 10.7% for the media and substrate markets, respectively, and both markets will exceed 1 billion units later in the five-year forecast period. The market is grappling with two highly anticipated transitions. The 3.5 inch market introduced 160 GB/disk in 2006, and the 2.5 inch-and-smaller markets are moving into perpendicular recording.

TrendFocus also reported in their Rigid Media & Substrate Information service 2006 annual report that disk media volumes would grow from 630.57 million in 2005 through to 1,132.96 million in 2010, a compound annual growth rate of 12.4%. Our acquisition of key magnetic disk media handling technology in 2004 and our acquisition of precision cleaning process technology in 2005 positions us well to take advantage of this dynamic.

We design, develop and manufacture process automation solutions that enable customers to test and produce highly reliable disk drives and magnetic disk media with greater efficiency and at a lower cost. In addition, our next-generation test systems allow our customers to load, test and unload each drive individually and asynchronously. Our patented asynchronous testing systems reduce the time required for

processing disk drives, allowing for a more efficient use of capital equipment. We have established long-term relationships with leading disk drive manufacturers, including Seagate Technology and Western Digital.

Our Competitive Strengths

Disk drive technology is a fundamental building block of any network storage system. We believe our leadership in developing and providing high-density automation and disk drive test equipment, combined with our experience in developing high-density networked storage subsystems, has uniquely positioned us to understand our customer needs and drive innovation in both our product segments. In particular, we believe that the following attributes of our business position us to take advantage of market opportunities:

Leadership in High-Growth Market Segments

We are an established leader in key segments of the external storage and networking markets. We are the leading subsystem provider to OEMs in the NAS systems segment and based on data from IDC we believe we ship over 14% of the shipments in terms of terabytes in the worldwide external storage systems market. We are also the leading independent supplier of disk drive production test and servo track writing process equipment to the disk drive industry. We estimate that over 55 percent of all 3.5 inch disk drives shipped worldwide and over 20% of the 2.5 inch disk drives shipped worldwide are processed through our technology in either the servo writer or final test and qualification processes. We are well positioned to become a leader in providing technology to OEMs in Capacity-Optimized Storage Systems segment. This segment integrates high density desk top drives into the enterprise storage systems market by incorporating SATA and SAS disk drive technologies. SATA based systems provide a key, cost effective enabler for such data storage, disk-to-disk backup and NearLine applications. These systems, coupled with advancements in virtualization software are enabling growing implementation in tiered storage architecture.

Excellence in Technology Innovation

We are a leader in high-specification design of high-density, scalable, storage subsystems and automated process test equipment. We are also a leader in the development and integration of network communication protocols and switching technologies. As of November 30, 2006, we employed 396 research and development professionals, which represent 26% of our total employees. Our position as a leader in providing networked storage subsystem technology and disk drive automation and process test equipment has enabled us to deliver innovative and first-to-market products that complement our customers core competencies.

Our history of innovation and first-mover positioning has contributed to our success in winning large OEM contracts and developing long-term customer relationships. For example, in 2002 we were first to offer our OEM customers the new switched bunch of disks, or SBOD, technology. This innovative technology can offer substantial increases in performance, data availability and serviceability in certain customer applications. We demonstrated our third generation SBOD incorporating four gigabits per second Fibre Channel technology in 2004. We also demonstrated SAS storage systems with SAS host connection through SAS expander technology in 2004. In 2005 we announced a number of significant patent filings in the areas of optical backplane interconnect and revolutionary congestion management techniques required in multi stage switching networks. In 2005 we also demonstrated our high density 4U networked storage solution which contained 48 high capacity SATA drives attached to a fibre channel network. In 2006 we demonstrated direct SAS attachment to this high density solution. We also began shipments of mixed SAS and SATA tiered storage solutions and demonstrated a high density application focused storage solution. These 4U storage systems contain 24 high density hard disc drives integrated with Storage Bridge Bay (SBB) compliant controller and application blade technology modules.

In 2002, we were first-to-market with a revolutionary high-density automated disk drive production test process. This process automation significantly increases the process efficiencies within the final test and qualification stages of disk drive production, and enhances the competitive positioning of our customer base. In 2004 we optimized the automated production test process platform for 2.5 inch drives, reflecting the growing importance of the smaller form factor technology within our customer base. We continue to research opportunities for automated optical inspection processes in magnetic media production processes.

Strategic Relationships with Technology Leaders

We have established long-term strategic relationships with many of our customers including our two largest customers: Network Appliance and Seagate Technology. They rely on us to deliver high-quality products, which they often integrate into their branded product offerings or processes. We have successfully taken advantage of the trend towards technology outsourcing. We enter into joint development projects with our key customers and suppliers in order to research and introduce new technologies and products. By sharing intellectual and financial capital and resources with other technology leaders, we are able to provide our customers with high-performance and innovative products.

Strong Revenue Growth and Performance

We have increased our revenues from continuing businesses from $83.6 million in our fiscal year ended November 30, 1999 to $983.6 million in our fiscal year ended November 30, 2006, representing a compound annual growth rate of over 41%. We have over six years of sustained annual revenue growth, and over 26 consecutive quarters of year over year revenue growth. During this time we continued to make significant investments in research and development despite there being periods of constrained information technology spending in the market. We believe that the diversity of our product portfolio and our OEM business model has contributed to our strong performance during the recent global technology recession.

Since our establishment as an independent company in 1994, we have successfully grown businesses that we have subsequently divested for over $200 million in proceeds. This has enabled us to invest in our core business portfolio without utilizing significant external equity investments. As a result of valuable intellectual property and technical capabilities, our long-term established relationships with key customers, and our global supply and support infrastructure, we believe we are well positioned to continue our success.

Global Presence

Our presence in the United States, Asia and Europe is essential to establishing and maintaining our customer relationships. All of our core production facilities share common material planning and management systems and have integrated processes, which can be directed from any location. This enables responsive customer support and provides us with the flexibility to move manufacturing operations from one region to another in order to meet the logistics requirements of our customers. Our international presence also provides us with greater insight into market developments, local access to key suppliers and reduced production costs.

Growth Strategy

Our objective is to enhance our leadership position in providing networked disk storage solutions and disk drive automation and process test equipment. Key elements of our strategy include:

Expanding Our Relationships with Our Key Customers and Attracting New Customers

We have established key long-term relationships with several leading OEMs and disk drive manufacturers. We believe that our strategic relationships have enabled our customers to achieve time-to-market advantages and capital efficiencies, and to redirect their internal resources more efficiently into their core strategic value-added investment areas. Additionally, our leadership in both the storage subsystem and disk drive infrastructure markets provides us with insight into market trends and technologies that enables us to strengthen our strategic relationships and to expand our business. We will continue to focus our attention on our largest customers to seek new opportunities while continuing to provide them with advanced products. While we maintain our focus on our established customers, we selectively pursue relationships with new and emerging technology market leaders. We believe that the reputation we have developed through servicing our established customers enables us to attract and retain new customers.

Capitalizing On and Expanding Our Technical Expertise and Continuing to Introduce Innovative Products

We have a consistent track record of introducing innovative products, including JBOD, SBOD and RAID storage subsystems, disk drive servo track writers and disk drive production testers. We will continue to leverage our technical expertise through ongoing investment in research and development, seeking both to enhance our current product offerings and develop new technologies and products. We expect to both develop products and technologies on our own and to form strategic relationships with our customers to meet their specific requirements. We believe that joint development projects will continue to enhance our ability to focus our research and development investment in areas of strategic importance. We will continue to develop the enabling technology for higher density and smaller disk drives. Technologies that we are focused on include emerging industry high-speed communication protocols, such as iSCSI, SATA, Advanced Switching, or ASI, PCI express, Infiniband, next-generation Fibre Channel, SCSI and 10 Gigabit Ethernet. We are also focused on integrating optical technology into our products and assessing the technology requirements beyond ten gigabits per second so that we can continue to exploit opportunities with our customers in the future.

From time to time we may also acquire companies which possess technologies that we believe are important to our strategic development. Examples of this type of activity include our acquisition of both the magnetic disk media automation technology in February 2004 and the acquisition of intellectual property for advanced optical inspection systems in September 2004. In 2005, we acquired precision cleaning process technology through the acquisition of Oliver Design. The application of both automation and cleaning process technology integrated with disk inspection technology will enable us to drive further process innovation and efficiencies for our customers. In September 2005 we added captive RAID technology to our storage system enclosures through the acquisition of nStor. Historically we have only been able to access the RAID market opportunity through third party suppliers. The integration of our own RAID controller technology with our storage enclosures also enables the opportunity to invest in additional software technology increasing our overall value-add to our customers.

Leveraging Our Resources and Intellectual Capital Across Our Businesses

We seek to apply our intellectual capital and resources in several sectors within the data storage and networking markets. This allows us to effectively allocate our resources by directing them to the most promising projects. We also seek to identify and capitalize on emerging technology and trends.

We believe there is synergy between our two business divisions with regards to system integration and testing of high-density disk drive solutions. For example, as new interfaces and disk drives are initially developed, our disk drive manufacturing customers need access to our process and test equipment. The development of disk drive process and test equipment gives us a significant time-to-market advantage on

any new issues or technology requirements which may impact the development cycle for our storage subsystems products. This has contributed to our ability to provide networked storage subsystem solutions early in the life cycle of new disk drive technology and offer our customers significant time-to-market advantages. We gain significant commercial leverage from our internal proprietary process technology within Networked Storage Solutions. This process equipment leverages over 20 years of experience in Storage Systems process design and manufacture.

Expanding Into Complementary Markets in Data Storage and Process Equipment Markets

In addition to growing within our existing market, we constantly seek to exploit our technology to expand into complementary high-growth areas within the data storage and process equipment markets. For example, we have grown our leadership position in the disk drive process and test equipment market through a targeted joint development process within our customer base. We successfully expanded from shipping product in one segment of this market in 1998 to four market segments in 2005. In 2006 we were selected to provide equipment to a customer in the solar power market, our first engagement outside the data storage market. This was through leveraging process automation technologies previously deployed within the data storage segments but adapted to the new requirements of the solar market.

Our strategy is also to make incremental technology acquisitions to deepen our penetration of existing markets and create the potential to grow our margins or to facilitate entry into new market segments supported by our existing customer base. We have been successful in implementing this strategy to create the synergistic business streams we have today and will continue to execute and expand this strategy in the future. Our OEM storage subsystems customers have identified several emerging opportunities for our technology beyond the traditional storage interconnects associated with the switches used in Fibre Channel or IP SANs or LANs. Our strategy is focused on developing the basic technology building blocks which will address the needs of networked storage systems, system area networking, grid computing and high-performance computing market segments. Examples of our acquisition strategy include our acquisition of the business of ZT Automation LLC in February 2004. The acquisition has provided us access to magnetic disk media handling automation technology used in the disk drive production process. On September 2, 2004 we acquired the intellectual property of Beyond3, a developer of advanced optical inspection systems based in San Jose, California. This technology has the capability to integrate with magnetic disk media handling automation and has the potential to enable even deeper access to magnetic disk production processes. This technology also has the potential to allow us to access any market where there is value in the deployment of automated optical inspection systems. In February 2005 we acquired the rights to important intellectual property incorporated inside an extensive Linux code base from both Cap Epsilon of California and Vedams of Hyderabad, India. This code enabled an earlier time to market for the new product line, Application Storage Systems. Application Storage Systems integrate ATX motherboard technology inside a storage enclosure so that they can be more readily deployed in many new entry level storage applications within the Healthcare, Video, IP storage and SAN markets. In May 2005, we acquired the business of Oliver Design, Inc, a company located in Scotts Valley, California, which develops and sells precision cleaning process technology for use in the magnetic disk media drive production process. In September 2005, we acquired nStor, a company headquartered in Carlsbad, California, and which was a developer and provider of data storage RAID technology, primarily to OEMs. In September 2006 we acquired the business of Jastam Trading Co. Ltd, a company located in Tokyo Japan. Jastam was a full service broker for equipment suppliers to high technology customers in Japan.

Our Products

Our operations are divided into two business segments, Networked Storage Solutions and Storage Infrastructure.

Networked Storage Solutions

We design, develop and manufacture modular, highly scalable, high-speed, high-density, reliable and flexible data storage. Our storage subsystems support a range of high-speed communication technologies and cost and performance specifications.

Our modular subsystem architecture allows us to support many segments within the network storage market by enabling different specifications of storage subsystem designs to be created from a set of interlocking technology modules. The specific configuration of the embedded technology modules within any storage subsystem can be tailored to meet cost, performance, network connection interface, data protection and system availability requirements. Our configuration options include: a range of storage controller devices to protect and manage data; a range of connection options to attach to various high-speed networks; fail-safe internal power systems; and embedded switching technology to improve overall system reliability and performance.

Our storage subsystems are internally managed by a range of software modules and features. These software modules can monitor the internal performance of the subsystem, create high-availability internal environments, communicate independently with remote service, support organizations and integrate seamlessly with our customer s controlling software and management technology through industry standard interfaces.

Our storage subsystems address the challenge of effectively managing the increasing proliferation of both data and network technologies to ensure that data can be made available and shared across organizations in a reliable and scalable fashion.

We sell our storage subsystems primarily to OEMs and work with them to design and configure our products to meet their specific price and performance objectives. Our storage subsystems are the underlying platforms for networked storage environments, which include NAS, Fibre Channel SAN, as well as emerging IP storage. We design and manufacture four product lines of storage subsystems:

JBOD Subsystems. Our JBOD subsystems are high-density storage enclosures that can be configured to specific applications, including changes to disk drive form factors and the number of drives per enclosure. This includes configurations of 8, 12, 14, 16 and 48 disk drives per enclosure. Our subsystems currently integrate high-speed Fibre Channel, low-cost SATA, ATA and enterprise-class SCSI (SAS) protocol disk drives.

SBOD Subsystems. Our SBOD subsystems provide a cost effective alternative to the Fibre Channel loop architecture in a traditional Fibre Channel JBOD with embedded switch technology. The SBOD s switched backplane is an embedded switch with integrated network monitoring capability. This offers substantial increases in performance, data availability and serviceability. Our embedded switch technology enables individual drive performance to be monitored so that any degradation of individual disk drives can be identified. Traditional Fibre Channel loop architectures do not offer this monitoring capability.

RAID Subsystems. Our RAID subsystems are highly reliable storage enclosures that offer data protection capability in the event of a drive failure. Our subsystems consist of a JBOD or SBOD integrated with one or more controller devices that manage data on disk drives. The controller directs access to the data so that if a disk drive fails other disk drives in the RAID system can be used to recover data that was lost from the affected disk drive. Our RAID subsystem can be configured to optimize performance, costs and data recovery time.

Application Storage Systems. Application Storage Systems integrate ATX and SBB motherboard and server blade technology modules inside a storage enclosure integrated with the necessary driver and specialist utility software modules to adapt to many different storage application requirements. Various network connections can be further integrated into the competitively designed storage enclosures making

them excellent platforms to address the entry level requirements of the Healthcare, Video, IP storage and SAN markets.

Our modular approach minimizes the need for numerous different product designs and reduces the development time for a new configuration. Our storage subsystems may be configured to deliver varying combinations of size, storage capacity, communication protocol, RAID functionality, component redundancy and management software. Another benefit of the modular design of our products is that it enables end-users to easily scale their storage capacity by adding components and storage subsystems to their existing infrastructure.

Our storage subsystems have integrated software modules which fall into two distinct categories, embedded software modules and high-level user-oriented programs.

Embedded Software Modules. The embedded software modules control and monitor the internal infrastructure of the storage subsystems enclosure. They perform basic monitoring tasks and are capable of providing detailed status reports on the enclosure s overall health and recent performance history. The embedded software modules:

- control enclosure temperatures, communication chips, cooling fan speeds, status lights;
- control operation of, manage and integrate the SBOD Fibre Channel embedded switch; and
- report data for remote control software to control the enclosures using legacy interface standards, such as SCSI Enclosure Services, or SES, and SCSI Accessed Fault Tolerant Enclosure, or SAFTE, and emerging interface standards, such as Common Interface Module (CIM) and Storage Management Initiative Specification (SMI-S).

Emerging interface standards attempt to add more capability and better define the way devices behave and pass communications to each other, by improving device interoperability, simplifying network management processes and standardizing and enhancing the device-level information within high-speed storage networks.

High-Level User Oriented Programs. The high-level user oriented software programs form a set of utility tools to manage and configure the data structures stored on the storage subsystems, setting the level of security and data protection for each logical data volume within the enclosure. Logical data volumes are a fixed amount of storage space, usually spread across many disk drives and are treated as independent physical storage units by the attached host operating systems. A logical data volume can be shared by many users with programmable access controls to provide a level of data security. The programs can run on a wide variety of computer operating systems including Windows, Linux and a variety of other Unix-based systems. The principal features of these programs include:

- creating and maintaining logical data volumes within storage subsystems;
- establishing permissions and rules to control access to data space within storage subsystems;
- editing settings for speed, space, redundancy, fault tolerance and reliability within allocated data space within storage subsystems;
- creating fast data recovery processes, such as mirrors and snapshots, in the event of software or hardware failures; and
- managing and reporting processes for system errors and hardware failures.

All these software tools integrate with and complement the expanded management and software features within our customer s overall management system architecture.

Storage Infrastructure

We are the leading global independent provider of disk drive production test, media automation, servo-track writing equipment and disk cleaning systems. Our Storage Infrastructure products enable our customers to test and produce highly reliable disk drives with greater efficiency and at a lower cost. Over the past few years, we have provided production equipment to leading disk drive manufacturers and their component suppliers, including Komag, Maxtor Corp., Seagate Technology and Western Digital. Our Storage Infrastructure products are capable of covering all disk drive form factors, including 3.5 inch, 2.5 inch, 1.8 inch, 1.0 inch and 0.85 inch disk drives. These products include:

Disk Drive Production Test Systems. We design and manufacture fully automated process test systems which incorporate mechanical and electronic hardware and software that control the operating environment of disk drives during final qualification testing. This test process isolates any magnetic defects from each drive during an extensive period of testing that can exceed 100 hours for current generation high capacity disk drives. Our test systems can be configured to meet the specific requirements of individual customers and can be integrated with our customers technology. Our test systems are capable of testing a full range of disk drive protocols and form factors that are currently available on the market. Protocols include high-speed Fibre Channel, low-cost SATA, ATA and enterprise-class SCSI protocol disk drives.

Servo Track Writers. We design and manufacture both complete servo track writers and their key subassemblies, using a modular approach. Servo track writers are required in the production of all disk drives to write digitally generated magnetic reference patterns on the surface of the disks at a very high speed. These reference patterns are used to precisely define the position of data on the disk. Our products enable the two most significant methods of servo track writing: media writing and self servo writing. Media writing is a process in which a stack of disks is written with servo patterns and then individually assembled into a number of disk drives. In self servo writing, the pattern is written on the disk within the drive without using special external hardware.

Media Automation Solutions. Our media automation solutions cover all major aspects of magnetic disk media processing requirements, including product handling, cassette transport with intelligent routing, product tracking disk stacking and process management software. Disk automation solutions require precision technology and sophisticated techniques to provide the efficiencies that only an integrated approach to process and system design can deliver. This is why we work closely with customers to ensure that our solutions are designed to integrate tightly with specific production environments, yet remain modular and flexible enough to grow as needs change.

Disk Cleaning Systems. Our range of precision disk cleaning systems represents the latest in cleaning technology and performance for the disk drive industry. The precision cleaning system architecture allows for the customization to a range of magnetic media process requirements by the integration of a range of advanced technology modules. These include ultrasonics and megasonics, cassetteless handling, cascade scrubber and Hot IPA Vapor Assist Dryer modules which enable some of the most flexible systems configurations available.

Our modular design approach enables us to provide a broad range of process equipment to a wide variety of segments of the disk drive markets, including the enterprise storage system, laptop and desk top personal computer, and the consumer electronics segments. Our product options provide solutions supporting a range of disk drive physical shapes; high-speed disk drive interface connections; and high-density disk drive production process requirements. These options can be integrated with fully automated control and handling systems.

These products provide disk drive manufacturers cost efficiencies, time-to-market advantages and enable them to prioritize their internal resources in order to achieve their strategic objectives.

Customers

Our business is based on long-term strategic relationships with our customers. We have been successful in cultivating these relationships and have historically experienced a stable customer base. Our major customers are the OEMs who supply storage systems and networking products to the eventual end-user, and large corporations who supply components to those OEMs. Our strategy is to provide our products to leading OEMs and other companies that we anticipate will be future market leaders.

We have over 150 customers, of which the top two customers are Network Appliance and Seagate Technology. In our 2006 fiscal year sales to these customers accounted for 46% and 28% of our revenues, respectively, in total 74% of our revenues. During our fiscal year ended 2005, our top two customers accounted for 78% of our revenues. The loss of any of our top two customers could significantly harm our financial condition. We believe that since our separation from IBM in 1994, we have not lost a key customer to a competitor. In 2006 we established over fifteen new customer accounts expected to contribute more than $0.5 million in annual revenues each.

Customer Contracts

Our contractual relationships with our top three customers are governed by framework supply agreements. Actual sales and purchases of our products are made pursuant to individual purchase orders issued under the respective framework supply agreement. Our customers issue purchase orders for the supply of specified products on an as needed basis. Each framework supply agreement sets forth the general terms and conditions governing individual purchase orders, an initial minimum price list for each of our products and a form of forecasted supply schedule for the products to be supplied. The minimum price lists and forecasted supply schedules are non-binding. We frequently issue revised price lists and issue new forecasted supply schedules. The framework supply agreements also:

- require us to notify the customer of engineering changes to our products;
- provide that we retain intellectual property rights to our products and any improvements to our products and to all foreground intellectual property and technology;
- grant the customer a nonexclusive, worldwide, license to use our intellectual property in the customer s product offerings; and
- contain certain non-disclosure, confidentiality, assignment, termination, product and manufacturer s warranty, inventory consignment, and indemnification provisions.

ISO 9001 Registrations

As part of IBM UK Limited, the Havant site first achieved certification to BS 5750 Part 1 (the forerunner of ISO 9001) in 1984 and we have continued to the present day to be registered to the equivalent of ISO 9001 at our headquarters, adding to this ISO 9001 registration for the locations at Seremban (1999) and Sacramento (initially ISO 9002 in 2000 then ISO 9001 in 2001).

Environmental Commitments and World Wide Legislation

Xyratex aims to identify and minimize the negative environmental impacts of its products and business activities, specifically to ensure that:

- Xyratex complies with all relevant environmental legislation and regulations;
- we reduce the use of materials, or alternatively re-use, recycle and recover materials, to minimize the overall consumption of natural resources and prevent pollution;
- we support our customers in the pursuit of their environmental objectives;

- we communicate appropriately on environmental matters internally and externally;
- we present an image which accurately reflects our environmental performance and objectives; and
- we continually improve our environmental performance.

Xyratex will prohibit the use of all substances identified within the RoHS Directive (restriction on the use of certain hazardous substances) and the Chinese Administration on the Control of Pollution Caused by Electronic Information Products law (China RoHS). It is Xyratex s objective, where possible, to ensure all of its products sold within the European Union and China comply with these directives and laws. Xyratex is committed to designing for the environment to ensure all products are capable of being recycled within the requirements of national and international legislation.

In 2005 Xyratex successfully met the compliance requirements for ISO 14001 for its UK research and production facility in Havant. Our strategy is to achieve ISO 14001 registration at our manufacturing locations and compliance across all of our worldwide locations over time.

Research and Development

We have over 20 years of research and development experience in disk drive development, storage systems and high-speed communication protocols. We believe we have been first-to-market with several of our data storage subsystem and test and process equipment products that complement our customers core competencies and objectives.

Our research and development program is focused on the development of new and enhanced products that can support emerging communication protocols while continuing to accommodate legacy technologies. We believe that this focus positions us to capitalize on emerging technologies and standards, such as iSCSI and SAS, while continuing to support existing technologies, such as Fibre Channel, SCSI, SATA, ATA and both Gigabit Ethernet and 10 Gigabit Ethernet. We have also invested significantly in software and the design of programmable logic devices, such as Field Programmable Gate Arrays, or FPGA, and in the integration of switching technology into our range of storage subsystems.

We typically undertake between eight to ten significant research and development efforts each year, in addition to a number of smaller research and development projects. In the year ended November 30, 2006, we have engaged in 30 research and development projects related to our Networked Storage Solutions business and 16 projects related to our Storage Infrastructure business. Approximately 16 of these projects are focused on developing new technologies or applications and the remainder are focused on improving existing technologies or applications. We review the status of all of our active research and development projects semi-annually and make adjustments to the investment levels of these projects as needed.

Over the past three fiscal years, we have increased our research and development expenditures each year and have spent an aggregate of $181.1 million (including $25.9 million of equity compensation and a benefit of $6.0 million in connection with a development arrangement with a supplier) during this period. We have consistently maintained over 26 percent of our employees in research and development during this period. These employees have an average of over ten years of experience in research and development.

We believe that our future success will depend in part on our ability to continue to deliver advanced products and technologies to all of the markets we serve. We maintain close long-term relationships with industry-leading companies, including both customers and suppliers, in order to develop tailored products to meet specific customer requirements. We enter into joint development projects with our customers. Our close relationships with both customers and suppliers give us an insight into industry trends and the future needs of the industry which enables us to focus and prioritize our investment in future research and development.

We carry out our research and development activities in Havant, United Kingdom; Chicago, Ithaca, Lake Mary, San Jose, Scotts Valley and Colorado Springs, United States; and Seremban, Malaysia.

Intellectual Property

Our success is dependent upon our ability to develop and maintain the proprietary aspects of our technology and to operate without infringing the proprietary rights of others. We rely on a combination of patent, copyright, trademark and trade secret laws, and generally have intellectual property agreements governing our relationships with our customers, suppliers, employees and consultants. As of November 30, 2006, we had 100 U.S. patents granted, 63 U.S. patents pending, 71 non-U.S. patents granted and 129 non-U.S. patents pending.

In order to enhance our intellectual property we also seek to acquire or obtain cross-licenses with industry partners. In December 2006 we entered into a cross-license with IBM. This enabled our Networked Storage Solution business to leverage valuable IBM intellectual property into the roadmaps of our OEM technology business. A recent analysis we have made of the intellectual property landscape for this business showed that the IBM patent portfolio had the dominant share of patents by volume and relevance. Historically we have had to design around this portfolio as we move forward with our technology roadmap. We will now be able to freely use any of IBM s patents or filings and incorporate them into our roadmap. The cross license with IBM should therefore make the initial product architecture phase more efficient as we develop new technology for customers.

We have documented internal processes for the management and protection of our intellectual property. These include standard forms for patent filing, design and trademark registration, employee and contractor supplier agreements, and non-disclosure agreements. We file patent applications when we consider patent protection to be the most appropriate and commercially practical means of protecting our intellectual property. We do not generally differentiate our products by their external design features, but we do register designs where we consider it appropriate. Many of our products are differentiated by their unique mechanical designs, which we have taken steps to protect under patent law. In addition, we have considerable expertise in the areas of very high-speed electronics and real-time data analysis software design.

We sell our products primarily to OEMs who incorporate them into their own branded products. As a result, branding is not an important aspect of our business. However, we have registered the Xyratex trademark and other trademarks specific to certain of our products.

Manufacturing and Operations

Our operational strategy is to provide production facilities in close proximity to our customer base. Our production facilities are based in Sacramento, San Jose and Scotts Valley in California, United States; Seremban, Malaysia; and Havant, United Kingdom. These facilities share common material planning and management systems and integrated processes which are accessible from any location. This enables responsive customer support and provides us with the flexibility to move manufacturing operations from one region to another in order to meet the logistics requirements of our customers. Our production facilities also attempt to use common quality control processes which we believe help to ensure that all of our products, irrespective of their place of manufacture, meet the quality expectations of our customers. However, over the next two years we are planning to transition to SAP, a replacement Enterprise Resource Planning system, across the whole company. We have adopted a phased deployment across the company. Scotts Valley acted as a pilot location and successfully converted to SAP in 2006. The phased SAP roll out will lead us to lose some of the above company-wide efficiencies within the transition period. We will maintain significant system and skill commonality within each division but efficiencies across the whole company will be reduced due to the dual system operation within the transition period.

We have established strategic relationships with a number of key suppliers for the supply of our core components and subassemblies, including printed circuit board assemblies, hard disk drives, plastic mouldings, power supplies and sheet-metal fabrication. In 2006, for certain of our product lines, we also outsourced higher level box assembly to one of our suppliers. Our production facilities are focused on material planning, high-level assembly operation, system testing and customer fulfillment activities.

We have an agreement with Solectron Corporation, one of the largest third-party providers of customized integrated electronic manufacturing services, to manufacture electronic cards for use in our products. We purchase all of the electronics cards used in our products from third party vendors, but maintain card design and development expertise in-house. We work closely with Solectron and others in order to effectively manage our electronic card inventory, to control component costs, and to incorporate design upgrades. Our agreement with Solectron is a trading agreement which sets forth the basic terms of the supply arrangement but does not contractually commit us to order electronic cards from Solectron. We order electronic cards from Solectron through purchase orders, on an as needed basis, as described in Supply Arrangements below. Our trading agreement with Solectron:

- permits assignment of the trading agreement by us or Solectron with written consent;
- provides that the trading agreement may be terminated in the event that Solectron becomes bankrupt or enters into receivership;
- prohibits the disclosure of Xyratex confidential information to third parties and requires that Solectron obtain our prior approval before publicizing or advertising certain products;
- contains product quality warranties that require electronic cards supplied by Solectron to comply with our specifications;
- requires compliance with health and safety at work laws and regulations including laws and regulations relating to the control of hazardous substances;
- stipulates ownership, use, quality, service and maintenance procedures relating to tooling owned by Xyratex that is used by Solectron and held at Solectron s site;
- specifies the carriage and insurance costs to be paid in connection with the delivery of electronic cards and constituent parts; and
- sets forth procedures for the provision of notice of the obsolescence of electronic cards or constituent parts.

Supply Arrangements

We order parts from our suppliers through purchase orders, on an as needed basis. Each purchase order we issue specifies the component required and any related design specifications and the price for the component based on frequently updated price lists. In addition, with certain suppliers, we have also implemented trading agreements to clarify specific business practices and agreements between ourselves and the supplier. These trading agreements do not contractually commit us to order goods or services from these suppliers, nor do they restrict us from obtaining equivalent goods or services from other suppliers. The trading agreements can also:

- provide that we retain all rights to intellectual property developed or created for us by our suppliers;
- grant the supplier the right to apply for patent protection on any invention developed by the supplier in connection with its supply of components to us and grant us a nonexclusive, worldwide, license to use any patents granted;

- contain assignment, termination and confidentiality provisions and quality warranties;

- make provision for a royalty bearing manufacturing license upon either Xyratex ceasing to trade, or being acquired by a competitor of our major customers, or be in material breach of contract. This license would usually also grant rights of access to any technical information required to make the license usable;

- contain commitments to work with our customers on specific cost improvement programs; and

- define any quality and shipping control requirements and define corrective processes, procedures and penalties incurred in managing any exceptions.

Sales and Marketing

We market and sell our products primarily to leading OEMs and disk drive manufacturers, and to a small number of other companies. Our sales and marketing activities are actively supported by our senior business development managers and key individuals from our research and development team. Because these employees have an in-depth understanding of our products, we believe they are well positioned to provide support to sales and marketing activities and serve the needs of our customers. Our sales and marketing model also allows us to develop strategic relationships based on our technical know-how. Although we do not maintain a traditional sales and marketing group, we employ a number of sales representatives who support our sales activities in key markets by identifying potential new customers and managing our ongoing customer relations. We undertake certain targeted advertising, attend industry trade shows and participate in industry associations as part of our sales and marketing activities. As of November 30, 2006 we had 234 employees involved in direct sales and marketing activities.

Our sales and marketing efforts focus on acquiring new customers and deepening our relationships with our existing customers. Our relationships with new customers frequently begin with supplying key technology components and develop into arrangements for the provision of more comprehensive technology solutions. Our sales cycle is typically long and in some cases it can take up to 18 months for our new customers to evaluate our technology and business.

Our customers are primarily U.S. companies with global operations. We ship to their operations in the United States, Asia and Europe. The following table sets forth the percentage of our revenues generated from sales to customers in the United States, Asia and Europe, respectively, for the past three fiscal years.

	Year Ended November 30,		
	2006	2005	2004
United States	50.9 %	52.0 %	61.3 %
Asia	38.2 %	37.2 %	27.7 %
Europe	10.9 %	10.8 %	11.0 %

Competition

The market for Networked Storage Solutions and Storage Infrastructure products is competitive, and we expect this competition to increase. To maintain and improve our competitive position, we must continue to develop and introduce, on a timely and cost-effective basis, new product features and applications that keep pace with technological developments and emerging industry standards, and that address the increasingly sophisticated needs of our customers. The principal competitive factors affecting the market for our products are:

- early identification of emerging opportunities;

- being first to market with emerging technologies;

- complementing customer objectives without competing with customers;
- providing cost-effective solutions;
- maintaining high product performance and reliability;
- continuously expanding product scalability, flexibility and ease of use;
- delivering modular subsystem designs integrated with customer technology;
- offering support for emerging high-speed communication protocols; and
- increasing localized and responsive customer support on a worldwide basis.

We believe that we compete favorably with respect to each of these factors and have gained significant market share in many of our targeted markets. We believe our success has been driven by our technological leadership, our significant investment in research and development, our ability to generate customer loyalty and our track record of anticipating market trends.

We compete with companies active in providing storage subsystems and components to OEMs, including Dot Hill Systems Corp. and LSI trading as Engenio Information Technologies Inc. We face competition from internal development efforts of existing and potential customers. Such efforts can also be in collaborations with emerging technology companies. In addition, we face potential competition from new entrants including our current technology suppliers such as Sanmina-SCI (trading as Newisys).

Legal Proceedings

From time to time, we may become involved in legal proceedings relating to claims arising out of our operations in the normal course of business. In particular, others may assert patent, copyright, trademark and other intellectual property rights to technologies that are important to our business or make claims that we infringe their intellectual property.

We are not currently a party to any litigation or arbitration proceedings, nor are we aware of any threatened or potential legal proceedings which could significantly harm our financial condition.

Item 4c: Organization Structure

Xyratex Ltd is the parent company of the Xyratex Group. Xyratex Ltd directly wholly-owns all the significant subsidiaries in the group with the exception of Xyratex International Inc, which it owns indirectly.

The following table lists our significant subsidiaries:

Company	Country of Incorporation
Xyratex Technology Limited	United Kingdom
Xyratex Holdings Inc	United States
Xyratex International Inc	United States
Xyratex (Malaysia) Sdn Bhd	Malaysia

Item 4d: Properties

Our corporate offices and the center for our European research and development and production operations are located in Havant, United Kingdom, where we lease 77,000 square feet of office space and 35,000 square feet of manufacturing space.

Our U.S. research and development operations occupy leased facilities in Lake Mary, Florida, Ithaca, New York, Colorado Springs, Colorado and Chicago, Illinois. We maintain production operations in

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Sacramento, San Jose and Scotts Valley, California. In Lake Mary we lease 14,000 square feet of office space, in Ithaca we lease 9,000 square feet of office space, in Colorado Springs we lease 5,000 square feet of office space and in Chicago we lease 12,000 square feet of office space. In San Jose, we lease 36,000 square feet of office space, in Scotts Valley we lease 15,000 square feet of office space and 28,000 square feet of manufacturing space and in Sacramento we lease 17,000 square feet of office space and 96,000 square feet of manufacturing space. We also lease 1,500 square feet of office space in Carlsbad, California.

In Asia, our production and research and development operations are located in a 128,000 square foot facility in Seremban, Malaysia, which we own. Approximately 34,000 square feet of this space is office space and the remaining 94,000 square feet is manufacturing space. We also lease 9,000 square feet of office space in Penang, Malaysia, 5,000 square feet of office space in Singapore, 1,500 square feet of office space in Shanghai, China, 4,500 square feet of office space in Wuxi, China, 3,500 square feet of office space in Pathumthani, Thailand, and 2,500 square feet of office space in Tokyo, Japan, all for sales and customer support.

ITEM 4A: UNRESOLVED STAFF COMMENTS

None.

ITEM 5: OPERATING AND FINANCIAL REVIEW AND PROSPECTS (MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS)

You should read the following commentary together with the Selected Historical Consolidated Financial Data set forth in Part I, Item 3A and our consolidated financial statements and the related notes contained elsewhere in this Annual Report. This discussion contains forward-looking statements that involve risks and uncertainties. Our actual results may differ materially from those anticipated in these forward-looking statements as a result of many factors, including but not limited to those set forth in Part I, Item 3D Risk Factors and elsewhere in this Annual Report.

Overview

We are a leading provider of modular enterprise-class data storage subsystems and storage process technology. We design, develop and manufacture enabling technology that provides our customers with data storage products to support high-performance storage and data communication networks. We operate in two business segments: Networked Storage Solutions and Storage Infrastructure.

Our Networked Storage Solutions products are primarily storage subsystems, which we provide to OEMs and our Storage Infrastructure products consist of disk drive manufacturing process equipment, which we sell directly to manufacturers of disk drives and disk drive components. We form long-term strategic relationships with our customers and we support them through our operations in the United States, Asia and Europe. In our 2006 fiscal year, sales to our top two customers, Network Appliance and Seagate Technology accounted for 46% and 28% of our revenues, respectively. In our 2005 fiscal year, sales to these customers accounted for 48% and 30% of our revenues respectively. We had 49 customers which individually contributed more than $0.5 million to revenues in our 2006 fiscal year and 39 in our 2005 fiscal year. At November 30, 2006 we had over 150 active customers. We enter into joint development projects with our key customers and suppliers in order to research and introduce new technologies and products.

Acquisitions and disposals

On September 4, 2006, we completed the acquisition of Jastam Trading Co. Limited of Tokyo, a full service broker for equipment suppliers to high technology customers. The consideration for the acquisition of $1.7 million was paid in full in cash on completion and approximately represents the fair value of the tangible net assets acquired. The purchase of Jastam will enable us to better support current and potential future customers in Japan and is not expected to have a significant effect on future earnings in the short term.

We have recently completed a number of transactions to enhance the intellectual property base within our Networked Storage Solutions segment and generate income from our existing patent portfolio. These included the acquisition of a specific portfolio of patents from IBM, a general patent cross license arrangement with IBM and the acquisition of certain key assets and intellectual property from Ario Data Networks Inc. This represents a significant injection of intellectual property and will enable us to build more value add features and functions to the technology acquired as part of the acquisition of nStor Technologies, Inc. in September 2005. We also concluded two intellectual property licenses relating to the Xyratex portfolio of patents and filings. We licensed our network analysis patent portfolio to Napatech, a programmable network adapter company based in Denmark and licensed our cross bar switching patent portfolio to Virtensys, a U.K. technology start up. In total we have recorded purchases of intangible assets totaling approximately $9.0 million, of which $5.0 million was subsequent to the end of our fiscal year. We recorded other income of $3.2 million related to our license to Napatech.

In September 2005, we completed the acquisition of nStor Technologies, Inc., a company which was headquartered in Carlsbad, California and was listed on the American Stock Exchange. nStor was a

developer and provider of data storage subsystems, primarily to OEMs. The purchase price for the shares was $21.5 million in cash. In addition, as part of the acquisition, we were required to make other payments totaling $3.8 million and assume debt totaling $5.1 million. nStor recorded revenue of $7.3 million and $10.3 million in the six months ended June 30, 2005 and year ended December 31, 2004, respectively. nStor recorded operating losses of $4.2 million and $6.9 million, respectively in these periods. At November 30, 2006, we had substantially completed the integration nStor s business with our Networked Storage Solutions segment.

In May 2005, we acquired the business of Oliver Design, Inc., a company located in Scotts Valley, California, which develops and sells magnetic disk drive media cleaning technology for use in the disk drive production process. Our total cash consideration of $17.2 million consisted of an initial payment of $14.2 million and deferred consideration of $3.0 million due fifteen months from closing, which we recorded as an acquisition note payable. The deferred consideration was paid in August 2006.

In September 2004, we acquired the intellectual property of Beyond3, a developer of advanced optical inspection systems based in San Jose, California. The structure of the transaction involved an initial cash consideration of $1.3 million plus additional future payments of up to $17.2 million, $1.2 million of which is dependent on the achievement of certain product delivery milestones and up to $16.0 million of which is dependent on operating profit generated from the acquired intellectual property over the four years ending November 30, 2008. As of November 30, 2006, no additional payments had been made in respect of this purchase.

In June 2004 we completed an initial public offering in which we issued 4,000,000 common shares at $14.00 per share. The total proceeds from the common shares issued by us were $56.0 million and the net proceeds received by us after deducting underwriting discounts and other offering expenses was $48.1 million. Immediately prior to the closing of the initial public offering and in order to facilitate the listing of our common shares on the NASDAQ National Market, Xyratex Ltd, a Bermuda company, became the parent company of our business through an exchange by Xyratex Group Limited shareholders of their shares in Xyratex Group Limited, our previous parent company, for common shares of Xyratex Ltd. Xyratex Ltd was formed in April 2002 and had no operations prior to the initial public offering.

In February 2004, we acquired the business of ZT Automation LLC, a company located in Fremont, California, which develops and sells magnetic disk media handling automation technology for use in the disk drive production process, for a maximum total consideration of $29.0 million, which consisted of $6.6 million of initial consideration and $22.4 million of deferred consideration. Of the deferred consideration, $2.0 million was recorded as an acquisition note payable and was paid in February 2005. The additional amounts of deferred consideration of up to $20.4 million are payable based principally on a percentage of revenue generated by this business in the three years ending on December 31, 2006, calculated as 21.5% of cumulative revenue in excess of $19.6 million. The amount paid or payable based on revenue was $15.2 million at November 30, 2006.

Revenues

We derive revenues primarily from the sale of our Networked Storage Solutions products and our Storage Infrastructure products.

Our Networked Storage Solutions products consist primarily of storage subsystems which address three market segments through our OEM customers; Network Attached Storage or NAS, Storage Area Networks or SAN and Capacity Optimized storage. We have continued to see strong growth in each of these market segments over the past two fiscal years, particularly through Network Appliance, our main customer addressing these marketplaces. Our customers typically operate across multiple market segments. Capacity Optimized storage is considered to be a new segment within the external storage systems market. It is

primarily driven by magnetic tape technology being replaced by storage systems containing low cost disk drive technology in the back up and recovery processes within enterprises. The deployment of low cost disk drives is also taking place within the SAN and NAS market segments as IT departments begin to classify their data as part of an information life cycle or corporate data management strategy. Our customers in each market segment currently use the Fibre Channel protocol to access the storage subsystem which can incorporate either high performance Fibre Channel or lower cost ATA/SATA disk drives.

Our Storage Infrastructure revenues are derived from the sale of disk drive manufacturing process equipment directly to manufacturers of disk drives and disk drive components and we have seen growth in these revenues over recent fiscal years, primarily through sales to Seagate Technology. We supply three main product lines in this segment: production test systems, servo track writers and media process technology (comprising media cleaning and media handling automation technology). We commenced the supply of media cleaning technology when we acquired the business of Oliver Design, Inc. in May 2005. Revenues from these products are subject to significant fluctuations, particularly from quarter to quarter, as they are dependent on the capital investment decisions and installation schedules of our customers.

We typically enter into arrangements with our largest customers and provide them with products based on purchase orders executed under these arrangements. These arrangements often include estimates as to future product demand but do not typically specify minimum volume purchase requirements. Due to the complexity of our products, we provide almost all of our products on a build-to-order basis. The prices of our products are generally agreed to in advance and are based on a pre-negotiated pricing model. The pricing model may specify certain product components and component costs as well as anticipated profit margins.

As described above, the unit prices we obtain from our major customers will typically vary with volumes. As products become more mature, prices will generally decline, partly reflecting reduced component costs. We also regularly introduce new products which are likely to incorporate additional features or new technology and these products will generally command a higher unit price. Average unit prices will also vary with the mix of customers and products. Our unit prices have reduced in the last two fiscal years as volumes with our major customers have increased and prices are adjusted in line with the agreed price/volume matrix. Because this is related to volume growth, this has not resulted in a reduction in our revenues and has also enabled reductions in component costs. With this exception, we have not seen an overall trend in our unit prices.

Some of these arrangements require non-refundable payments from our customers for research and development during the product development phase, which is known as non-recurring engineering or NRE . Revenue from non-recurring engineering under these contracts has been recognized upon the achievement of agreed project milestones and amounted to $1.9 million in our 2006 fiscal year and $0.8 million in our 2005 fiscal year. These amounts exclude compensation for product development received on cancellation of a customer order in 2006 as described below in the discussion of revenue. We do not anticipate any significant changes in the level of revenue from non-recurring engineering.

Sales of the major portion of our Storage Infrastructure products include an installation element. Revenue for these products is recognized upon installation except that, where there is objective and reliable evidence to support the fair value of installation, or where there is a separate arrangement for the installation, product revenue is recognized upon delivery. In addition, some of our sales contracts provide that a certain percentage of payments are to be made in advance of product delivery, in which case we record these payments as deferred revenue until the product is actually delivered.

We believe that both of our business segments present the opportunity for growth over the next several years. We are seeing growth in demand from our customers, which we believe relates to factors including increases in the amount of digitally stored information, increased information technology spending, growth in the specific markets which our customers address, the trend towards outsourcing and

increased market share of our customers. Growth in our Storage Infrastructure revenues is also specifically affected by the growth in shipped volume and increases in the individual storage capacity of disk drives.

The acquisition of Maxtor by Seagate Technology in May 2006 represents a significant consolidation among disk drive suppliers and has caused significant changes in market share. We believe these market share changes have resulted in an exceptional level of purchases of our equipment in our 2006 fiscal year as our customers invested in new capacity to capture increased market share. In addition we believe Seagate intend to reutilize certain Maxtor owned equipment, which was previously planned to be replaced by Xyratex equipment. Whilst the opportunity for growth in the longer term remains, we anticipate that for these two reasons revenues from our Storage Infrastructure products will decline in our 2007 fiscal year.

Foreign Exchange Rate Fluctuations

The functional currency for all our operations is U.S. dollars and the majority of our revenues and cost of revenues are denominated in U.S. dollars. A significant proportion (approximately $75 million in our 2006 fiscal year) of our non-U.S. dollar operating expenses relate to payroll and other expenses of our U.K. operations. To a lesser extent we are also exposed to movements in the Malaysian Ringgit relative to the U.S. dollar. We manage our exchange rate exposures through the use of forward foreign currency exchange contracts and option agreements. By using these derivative instruments, increases or decreases in our U.K. pound operating expenses resulting from changes in the U.S. dollar to U.K. pound exchange rate are partially offset by realized gains and losses on the derivative instruments.

Over our last three fiscal years there has been significant volatility in the exchange rate between the U.K. pound and the U.S. dollar. Overall in this period the U.S. dollar has fallen by approximately 14% relative to the U.K. pound. The effect of this volatility and movement is reduced because we have hedged the majority of our exposure to this exchange rate movement for approximately one year ahead. This historical exchange rate movement resulted in an increase in operating expenses in our 2005 fiscal year of approximately $6.0 million. There was no significant increase to our 2006 operating expenses arising from exchange rate movements, but if there are no further changes to the exchange rate, our 2007 operating expenses will increase by a further $3.0 million.

Costs of Revenues and Gross Profit

Our costs of revenues consist primarily of the costs of the materials and components used in the assembly and manufacture of our products, including disk drives, electronic cards, enclosures and power supplies. Other items included in costs of revenues include salaries, bonuses and other labor costs for employees engaged in the component procurement, assembly and testing of our products, warranty expenses, shipping costs, depreciation of manufacturing equipment and certain overhead costs. Our gross margins change primarily as a result of fluctuations in our product mix. Our gross margins also change as a result of changes to product pricing, manufacturing volumes and costs of components. The gross margins for our Networked Storage Solutions products tend to be lower than the margins of our Storage Infrastructure products and therefore our gross profit as a percentage of revenues will continue to vary with the proportions of revenues in each segment.

Research and Development

Our research and development expenses include expenses related to product development, engineering, materials costs and salaries, bonuses and other labor costs for our employees engaged in research and development. Research and development expenses include the costs incurred in designing products for our OEM customers, which often occurs prior to their commitment to purchase these products. We expense research and development costs as they are incurred.

Due to the level of competition in the markets in which we operate and the rapid changes in technology, our future revenues are heavily dependent on the improvements we make to our products and the introduction of new products. During our 2006 fiscal year our research and development expenses related to over approximately 46 separate projects and consisted of approximately $49.2 million related to improving existing products, $8.7 million to meet customer specific requirements and $11.5 million related to entering new markets, such as development of the Storage Bridge Bay (SBB) compliant Application Storage System.

As of November, 2006 26% of our employees were engaged in our research and development activities. Over recent fiscal years research and development expenses have risen approximately at the level of increase in revenue and we expect this trend to continue, reflecting our continuing commitment to developing products based on advanced technologies and designs.

Selling, General and Administrative

Selling, general, and administrative expenses include expenses related to salaries, bonuses and other labor costs for senior management and sales, marketing, and administrative employees, market research and consulting fees, commissions to sales representatives, information technology costs, other marketing and sales activities and exchange gains and losses arising on the retranslation of U.K. pound denominated assets and liabilities. Our selling, general and administrative expenses have increased over recent fiscal years as we have grown our business. To the extent our business continues to grow we would expect these expenses to continue to increase approximately in line with our revenues.

Provision for Income Taxes

We are subject to taxation primarily in the United Kingdom, the United States and Malaysia. Over 90% of our income before income taxes in the last two fiscal years has arisen in the United Kingdom or Malaysia. Since 1998, our Malaysian operations have benefited from high-tech pioneer status which provided us with a zero tax rate on substantially all of our income arising in Malaysia. In 2006 we were granted a tax exempt status for our operations in Malaysia until 2012, provided that we meet certain requirements. This removes the risk which previously existed, of a rise in our overall tax rate which would have occurred in 2007 when our high-tech pioneer status was due to expire. As of November 30, 2006, we recorded a deferred tax asset of $8.2 million related to loss-carry forwards and other timing differences in the United Kingdom. As a result of loss carry-forwards we have not been required to make any significant U.K. tax payments in recent fiscal years. Of the remaining deferred tax balance of $9.8 million, $5.7 million relates to equity compensation expense as described in the next paragraph and $3.3 million relates to net operating loss carryforwards recorded in connection with our acquisition of nStor.

Following the introduction of FAS 123R in our 2006 fiscal year, we have recorded equity compensation expense using the fair value method. This has resulted in the recording of a tax benefit of $1.8 million which is included in the deferred tax asset. The realization of this asset is dependent on future share price movements over the next four fiscal years as the awards vest. We anticipate recording any variation to the value of this asset as an adjustment to Additional Paid in Capital. As a result of the recording of equity compensation expense under the intrinsic method of our previous accounting policy in our 2004 fiscal year related to our Initial Public Offering in that year, we recorded an additional deferred tax asset of $12.3 million relating to share options granted to U.K. employees. This tax benefit primarily relates to a U.K. tax deduction which may be obtained when these share options are exercised, calculated as the intrinsic value on the date of our offering, being the excess of the market price over the exercise price on that date. As of November 30, 2006, as a result of employees exercising share options, $7.9 million of this amount had been added to U.K. loss carryforwards. The tax deduction is based on the intrinsic value on the date of exercise, which in our 2005 fiscal year was higher than that on the date of our offering. This windfall tax benefit, totaling $1.5 million, was added to Additional Paid in Capital. Following the

adoption of FAS 123R, windfall tax benefits will only be recognized when they are realized through a benefit to cash flow.

Tax payments in our 2006 fiscal year amounted to $1.0 million and, due to the beneficial Malaysian tax status and U.K. tax losses, these tax payments related primarily to our U.S. operations. We do not anticipate a significant change in the level of our tax payments in our 2007 fiscal year. The tax expense we recorded in our 2006 fiscal year, primarily relates to a reduction in the deferred tax asset arising from the usage of U.K. operating loss carryforwards.

In November 2005 we amended our legal structure whereby income earned outside the United Kingdom could be distributed to Xyratex Ltd, which is registered in Bermuda, without being subject to U.K. taxation. This substantially removed the risk that our tax rate would increase upon the expiry of certain beneficial elements of an international tax treaty between Malaysia and the United Kingdom. This change also resulted in a tax benefit of $0.9 million arising from the release of a provision for U.K. taxation on undistributed income in Malaysia.

Equity Compensation Expense

In our 2006 fiscal year we are required to record equity compensation expense using the fair value method required by Financial Accounting Standard (FAS) 123R Share Based Payment . Under our previous accounting policy we recorded equity compensation expense using the intrinsic value method prescribed by Accounting Principles Board Opinion (APB) 25 Accounting for Stock Issued to Employees . Equity compensation expense calculated under FAS 123R for the 2006 fiscal year was $7.2 million and we also recorded an income tax benefit related to this expense of $1.8 million. The net effect therefore amounted to $5.4 million and resulted in a reduction in our basic and diluted earnings per share. We anticipate recording $7.4 million in equity compensation expense over our next four fiscal years for share and option awards outstanding as of November 30, 2006. We also anticipate that this will increase as a result of the granting of additional share based awards in future periods and change as a result of changes in the assumptions on which the calculation of the equity compensation expense is based. We recorded an expense of $0.8 million in our 2005 fiscal year, related to 0.3 million share awards based on the prorated vesting of those shares during the period and calculated under our previous accounting policy.

In our 2004 fiscal year, as a consequence of our initial public offering, we recorded a non-cash equity compensation expense of $181.1 million calculated under the intrinsic method required by our previous accounting policy and including $1.0 million related to the vesting of share and option awards subsequent to the offering. Of this amount $168.1 million was included in continuing operations and $12.9 million was included in discontinued operations. We accordingly recorded a substantial operating and net loss in our 2004 fiscal year.

The equity compensation expense of $181.1 million is associated with the historical grants of Xyratex Group Limited class A preferred ordinary and class C ordinary shares totaling 10.6 million shares, and 3.8 million unexercised share options and other equity incentives awarded to our employees. U.S. GAAP requires that compensation expense for awards of shares, share options and other equity-based awards be measured on the first date that the number of shares that an employee is entitled to receive and the option or purchase price is known, referred to as the final measurement date. The final measurement date for grants of Xyratex Group Limited s class A preferred ordinary shares, as well as some of the share options, was the completion date of the initial public offering because the transferability restrictions associated with the shares lapsed on that date.

These equity compensation expense amounts are recorded as cost of revenues, research and development expense or selling, general and administrative expense, in accordance with the function of the relevant employee, or as discontinued operations for certain ex-employees.

Results from Continuing Operations

The following table sets forth, for the periods indicated, selected operating data as a percentage of revenues.

	Year Ended November 30,		
	2006	2005	2004
Revenues	100.0 %	100.0 %	100.0 %
Cost of revenues non-cash equity compensation	0.1		1.7
Cost of revenues other	79.8	78.8	77.7
Gross profit	20.1	21.2	20.6
Operating expenses:			
Research and development:			
Development arrangement			(1.3)
Non-cash equity compensation	0.2		5.2
Other	7.1	8.0	8.2
Selling, general and administrative:			
Non-cash equity compensation	0.4	0.1	29.7
Other	5.7	5.6	6.1
Amortization of intangible assets	0.5	0.5	0.2
In process research and development		0.5	0.2
Other costs			0.5
Operating income (loss)	6.1	6.6	(28.2)
Net income (loss) from continuing operations	5.9 %	6.2 %	(26.6)%

Fiscal Year Ended November 30, 2006 Compared to Fiscal Year Ended November 30, 2005

The following is a tabular presentation of our results of operations for our 2006 fiscal year compared to our 2005 fiscal year. Following the table is a discussion and analysis of our business and results of operations for such periods. A discussion of the non-cash equity compensation expense is set out above.

	Year Ended November 30,		Increase/(Decrease)	
	2006	2005	Amount	%
	(US dollars in thousands)			
Revenues:				
Networked Storage Solutions	$ 598,752	$ 415,379	$ 183,373	44.1 %
Storage Infrastructure	384,881	264,230	120,651	45.7
Total revenues	983,633	679,609	304,024	44.7
Cost of revenues non cash equity compensation	923		923	
Cost of revenues other	785,424	535,315	250,109	46.7
Gross profit:				
Networked Storage Solutions	82,762	64,831	17,931	27.7
Storage Infrastructure	115,447	79,463	35,984	45.3
Non cash equity compensation	(923)		(923)	
Total gross profit	197,286	144,294	52,992	36.7
Operating expenses:				
Research and development non cash equity compensation	1,962		1,962	
Research and development other	69,429	54,327	15,102	27.8
Selling, general and administrative non cash equity compensation	4,309	828	3,481	
Selling, general and administrative other	56,140	38,014	18,126	47.7
Amortization of intangible assets	5,123	3,218	1,905	
In process research and development		3,230	(3,230)	
Operating income	60,323	44,677	15,646	35.0
Other income	3,167		3,167	
Interest income, net	1,162	1,176	(14)	
Provision for income taxes	6,474	3,964	2,510	63.3
Net income from continuing operations	$ 58,178	$ 41,889	$ 16,289	38.9 %

Revenues

The 44.7% increase in our revenues in our 2006 fiscal year compared to 2005 fiscal year was attributable to increased sales of both our Networked Storage Solutions and Storage Infrastructure products.

Of the $183.4 million, or 44.1%, increase in revenues from sales of our Networked Storage Solutions products, management estimates that $78.3 million was contributed by an 85% increase in revenues from products incorporating low-cost disk drives. The remaining increase related primarily to growth of approximately 30% in sales of our storage subsystem products incorporating Fibre Channel disk drives. Both of these increases were driven largely by a continued growth in our sales to Network Appliance and also resulted from increased volumes from other customers, the introduction of new products and the contribution of new customers. We believe this reflects the increasing requirements for storage of digital information, particularly networked storage.

The $120.7 million increase in revenues from sales of Storage Infrastructure products included increases in revenues from each of our product groups. Revenues from the sale of media process technology increased by $31.7 million, including the contribution of $27.5 million for the first two quarters

of 2006 from sales of media cleaning equipment following our acquisition of Oliver Design in May 2005. Revenues from sales of production test systems and servo track writers increased by $67.4 million and $20.3 million, respectively. As described above, our revenues from our Storage Infrastructure products are subject to significant fluctuations, particularly between quarters, resulting from our major customers capital expenditure decisions and installation schedules. Management believe that, in addition to underlying growth in demand, the increase in revenues resulted from expansion of capacity by our customers as a result of the acquisition of Maxtor by Seagate and from an expansion of disk media production capacity in the environment of an ongoing constraint in the supply of disk media. Included in revenues is a $10.5 million charge to Maxtor for the cancellation of an order for production test systems, being compensation for product development costs and supply chain liabilities. As described in the overview although the longer term opportunity for growth remains, we believe that this increase in demand was exceptional and that added to a potential reutilization of Maxtor equipment by Seagate, revenues from this segment may decline significantly in our 2007 fiscal year.

Cost of Revenues and Gross Profit

The increase in cost of revenues and gross profit in our 2006 fiscal year compared to our 2005 fiscal year was primarily related to our growth in revenues. As a percentage of revenues, excluding the non-cash equity compensation expense, our gross profit was 20.1% for our 2006 fiscal year compared to 21.2% for our 2005 fiscal year. This decline in gross margin was primarily a result of a 1.8% decrease in the gross margin for our Networked Storage Solutions products.

The gross margin for our Networked Storage Solutions products decreased to 13.8% in our 2006 fiscal year from 15.6% in our 2005 fiscal year, primarily as a result of changes in product mix, in particular an increased proportion of revenues related to the lower margin disk drive component, and lower margins earned on new products introduced during the year.

The gross margin for Storage Infrastructure products was 30.0% in our 2006 fiscal year, essentially unchanged compared to 30.1% in our 2005 fiscal year. Although this reflects a number of offsetting changes to product mix, there were none which we consider to be individually significant.

In measuring the performance of our business segments from period to period without variations caused by special or unusual items, we focus on gross profit by product group, which excludes a non-cash equity compensation charge of $0.9 million for our 2006 fiscal year. See Note 19 to our condensed consolidated financial statements for a description of our segments and how we measure segment performance.

Research and Development

The $17.1 million increase in research and development expense in our 2006 fiscal year compared to our 2005 fiscal year includes a $2.0 million increase in equity compensation expense resulting primarily from the implementation of FAS123R as described above, approximately $3.6 million related to the operations of nStor and $3.7 million related to media cleaning technology as a result of our acquisition of Oliver Design in May 2005. In addition the increase included increased investment of approximately $7.0 million in a number of projects to enhance the technology content and broaden the range of our storage subsystems and $6.1 million related to increased investment in all of our significant Storage Infrastructure product lines. In November 2005 we ceased investment in silicon based switch architecture and the effect of this was to reduce our research and development expense by $5.3 million from that in the comparative period.

Selling, General and Administrative

The $21.6 million increase in our selling, general and administrative expense in our 2006 fiscal year compared to our 2005 fiscal year includes a $3.5 million increase in equity compensation expense resulting primarily from the implementation of FAS 123R, and the effects of our acquired businesses, including $3.0 million related to the nStor business and $2.0 million relating to the Oliver Design business. The remaining increase relates primarily to an increase in the number of employees engaged in sales and distribution activities in support of the increase in the level of business, but also includes a $0.8 million accounts receivable provision and a total of approximately $3.0 million in connection with reporting under Section 404 of the Sarbanes-Oxley Act of 2002 and implementation of a new ERP system.

Amortization of Intangible Assets

The $1.9 million increase in amortization of intangible assets in our 2006 fiscal year relates primarily to the effects of our acquisitions of nStor on September 9, 2005 and Oliver Design on May 23, 2005.

In Process Research and Development

In April 2005 we purchased intellectual property for $2.2 million consisting of a software suite which we intend to incorporate into a new Storage Appliance product line within our Networked Storage Solutions segment. The purchase price was recorded as an operating expense because the acquired software had not reached technological feasibility and had no alternative uses.

Other Income

We recorded income of $3.2 million in our 2006 fiscal year relating to the disposal of a product line to Napatech as described in the overview above.

Interest Income, Net

We recorded net interest income of $1.2 million in our 2006 and our 2005 fiscal years. This resulted from an increase in average interest rates offset by a decrease in average cash balances.

Provision for Income Taxes

During our 2006 fiscal year we recorded a provision for income taxes of $6.5 million compared with $4.0 million in our 2005 fiscal year. This was primarily as a result of the increase in income before income taxes. Both periods included adjustments to prior year tax liabilities of approximately $3.0 million.

Net Income from Continuing Operations

The increase in net income for our 2006 fiscal year compared to our 2005 fiscal year resulted primarily from an increase in revenues, including that from acquired businesses. The income from the disposal of a product line also contributed to the increase in net income. This was offset by factors set out above, including, in particular, the decrease in gross margins in our Networked Storage Solutions segment and the increase in operating expenses, including the effect of our acquisitions and $6.4 million related to an increase in equity compensation expense.

Fiscal Year Ended November 30, 2005 Compared to Fiscal Year Ended November 30, 2004

The following is a tabular presentation of our results of operations for our 2005 fiscal year compared to our 2004 fiscal year. Following the table is a discussion and analysis of our business and results of operations for such periods. A discussion of the non-cash equity compensation expense is set out above.

	Year Ended November 30,		Increase/(Decrease)	
	2005	2004	Amount	%
	(US dollars in thousands)			
Revenues:				
Networked Storage Solutions	$ 415,379	$ 318,692	$ 96,687	30.3 %
Storage Infrastructure	264,230	140,322	123,908	88.3
Total revenues	679,609	459,014	220,595	48.1
Cost of revenues non cash equity compensation		7,827	(7,827)	
Cost of revenues other	535,315	356,558	178,757	50.1
Gross profit:				
Networked Storage Solutions	64,831	56,282	8,549	15.2
Storage Infrastructure	79,463	46,174	33,289	72.1
Non cash equity compensation		(7,827)	7,827	
Total gross profit	144,294	94,629	49,665	52.5
Operating expenses:				
Research and development development arrangement		(6,000)	6,000	
Research and development non cash equity compensation		23,959	(23,959)	
Research and development other	54,327	37,429	16,898	45.1
Selling, general and administrative non cash equity compensation	828	136,363	(135,535)	
Selling, general and administrative other	38,014	28,005	10,009	35.7
Amortization of intangible assets	3,218	852	2,366	
In process research and development	3,230	1,169	2,061	
Other costs		2,388	(2,388)	
Operating income (loss)	44,677	(129,536)	174,213	
Interest income, net	1,176	1,052	124	
Provision (benefit) for income taxes	3,964	(6,239)	10,203	
Net income (loss) from continuing operations	$ 41,889	$ (122,245)	$ 164,134	%

Revenues

The 48.1% increase in our revenues in our 2005 fiscal year compared to our 2004 fiscal year was attributable to increased sales of both our Networked Storage Solutions and Storage Infrastructure products.

Of the $96.7 million increase in revenues from sales of our Networked Storage Solutions products, management estimates that $32.0 million was contributed by a 54% increase in revenues from products incorporating low-cost disk drives. The remaining increase related primarily to growth of approximately 24% in sales of our storage subsystem products incorporating Fibre Channel disk drives. Both of these increases were driven largely by a continued growth in our sales to Network Appliance and we believe this reflected the increasing requirements for storage of digital information, particularly networked storage. The increase in revenue also included the contribution of $5.0 million from our acquisition of nStor which took place close to the beginning of the fourth quarter of our 2005 fiscal year.

The $123.9 million increase in revenues from sales of Storage Infrastructure products primarily resulted from increases of $74.4 million in revenues from the sale of production test systems and $41.0 million in revenues from the sale of media process technology, including the contribution of $35.3 million from sales of media cleaning equipment following our acquisition of Oliver Design on May 23, 2005. Also in comparing these periods, revenues from the sale of servo track writers increased by $8.5 million. The changes in sales of these products related to the requirements of our major disk drive customers for these products which have been affected by the growth in demand for disk drives those customers are experiencing, both in terms of volume and individual disk drive storage capacity. As described above, our revenues from our Storage Infrastructure products are subject to significant fluctuations, particularly between quarters, resulting from our major customers capital expenditure decisions and installation schedules.

Cost of Revenues and Gross Profit

The increase in cost of revenues and gross profit in our 2005 fiscal year compared to our 2004 fiscal year was primarily related to our growth in revenues. As a percentage of revenues, excluding the non-cash equity compensation expense, our gross profit was 21.2% in our 2005 fiscal year compared to 22.3% for our 2004 fiscal year. This reflects decreases in the gross margin for both our Networked Storage Solutions and our Storage Infrastructure products, partially offset by an increase of 1.3% resulting from an increased proportion of higher margin Storage Infrastructure revenues.

The gross margin for our Networked Storage Solutions products decreased to 15.6% in our 2005 fiscal year from 17.7% in our 2004 fiscal year, primarily as a result of changes in product and customer mix, in particular the increasing proportion of lower margin products incorporating low cost disk drive technology and a reduction in sales of subsystems incorporating RAID technology, which attract a higher margin. In addition, the inclusion in our 2004 fiscal year of sales of a discontinued higher margin networking product and the timing of increases in manufacturing expenses associated with new capacity also contributed to the decrease in gross margin.

The gross margin for Storage Infrastructure products decreased to 30.1% in our 2005 fiscal year from 32.9% in our 2004 fiscal year. This was primarily the result of changes in product mix, including a reduced proportion of higher margin component sales relative to integrated system sales and a reduced proportion of higher margin automation products. These were partially offset by a 0.8% increase in margin as a result of operating efficiencies associated with the higher volumes.

In measuring the performance of our business segments from period to period without variations caused by special or unusual items, we focus on gross profit by product group, which excludes a non-cash equity compensation charge of $7.8 million for our 2004 fiscal year. See Note 19 to our consolidated financial statements included elsewhere in this Annual Report for a description of our segments and how we measure segment performance.

Research and Development development arrangement

In our 2002 fiscal year, as part of a development arrangement with a supplier, Chaparral Network Storage Inc, or Chaparral, we loaned $6.0 million to Chaparral in connection with the development of RAID controller components to be included in certain of our products. Because we believed that the repayment of these amounts was dependent on the successful efforts of the related research and development, the amounts were recorded as expense in 2002.

In February 2004, Dot Hill Systems Corp. acquired Chaparral and, based on the financial position of Dot Hill, we determined that the $6.0 million loan plus $0.9 million of accrued interest was collectible. Accordingly, we recorded a reduction in research and development expenses and additional interest

income for these amounts in our 2004 fiscal year. In August 2004, Dot Hill repaid the loan and accrued interest in full.

Research and Development other

The $16.9 million increase in other research and development expense in our 2005 fiscal year compared to our 2004 fiscal year includes increased investment of approximately $6.5 million in a number of projects to enhance the technology content and broaden the range of our storage subsystems, including $1.6 million in connection with a new Application Storage System product line related to the in-process research and development expense described below. Of the remaining increase, $0.8 million related to approximately three months expense resulting from our acquisition of nStor, $2.4 million related to media cleaning technology as a result of our acquisition of Oliver Design, $4.2 million related to investment in new Storage Infrastructure products including automation and optical inspection technologies following our acquisitions of ZT Automation and Beyond3 and $2.6 million related to changes in exchange rates. In addition, in November 2005 we ceased investment in silicon based switch architecture which resulted in an expense of $0.8 million, primarily being employee termination expenses

Selling, General and Administrative other

The $10.0 million increase in our selling, general and administrative expense in our 2005 fiscal year compared to our 2004 fiscal year includes the effects of our acquired businesses, $1.5 million resulting from our acquisition of nStor, $1.8 million resulting from our acquisition of Oliver Design and $0.5 million resulting from our acquisition of ZT Automation. The increase also included $2.1 million related to changes in exchange rates and a $2.1 million increase in insurance and other costs following our IPO. Additionally, we increased the number of employees engaged in sales activities in support of the increase in the level of business.

In process research and development

In April 2005 we purchased intellectual property for $2.2 million consisting of a software suite which we intend to incorporate into a new Application Storage System product line within our Networked Storage Solutions segment. The purchase price was recorded as an operating expense because the acquired software had not reached technological feasibility and had no alternative uses.

Amortization of Intangible Assets

The $2.4 million increase in amortization of intangible assets in our 2005 fiscal year includes $0.8 million and $1.1 million respectively from the amortization of intangible assets purchased as part our acquisitions of nStor on September 9, 2005 and Oliver Design on May 23, 2005.

Other Costs

In our 2004 fiscal year we incurred professional fees of $2.4 million in preparation for our initial public offering.

Interest Income, Net

We recorded net interest income of $1.2 million in our 2005 fiscal year compared to $1.1 million in our 2004 fiscal year. The interest income in the prior period includes the recognition of $1.1 million interest received on the loan made to Chaparral as part of the development arrangement described above. Excluding this amount, the recording of interest income in our 2005 fiscal year resulted from an increase in average cash balances, primarily related to the net proceeds from the issuance of common shares in connection with our IPO.

Provision (Benefit) for Income Taxes

During our 2005 fiscal year we recorded a provision for income taxes of $4.0 million compared with a benefit of $6.2 million in our 2004 fiscal year. This was primarily a result of the recording of an income tax benefit of $12.3 million relating to non cash equity compensation in our 2004 fiscal year. In addition, income tax expense increased by $2.1 million as a result of the increase in income before income taxes, the inclusion of an exchange gain of $1.2 million in our 2004 fiscal year and by $1.8 million because the development arrangement benefit in our 2004 fiscal year was not taxable. These effects were partially offset by a benefit of $3.3 million arising from an increase in income related to our Malaysian operation which is substantially exempt from income taxes, an adjustment to prior year reserves of $2.6 million and a $0.9 million benefit resulting from the legal reorganization of our group structure. The increase in income of our Malaysian operation results from the increased level of Storage Infrastructure revenue. The adjustment to prior year reserves results primarily from the agreement of certain prior year U.K. tax filings.

Net Income (Loss) from Continuing Operations

The recording of net income for our 2005 fiscal year compared to a net loss from continuing operations for our 2004 fiscal year resulted primarily from non cash equity compensation expense. Factors set out above, including, in particular, the increase in our revenues also contributed to the net income. The effects of these were offset by factors set out above, including, in particular, the decrease in gross margins and increases in operating expenses.

Quarterly Results of Operations

The following table sets forth, for the periods indicated, data regarding our revenues, operating expenses and net income. We derived this data from our unaudited consolidated financial statements and, in the opinion of management, this data includes all adjustments, consisting only of normal recurring entries, that are necessary for a fair presentation of our financial position and results of operations for these periods. The operating results in any quarter are not necessarily indicative of the results that may be expected for any future period.

	Three Months Ended							
	November 30, 2006	**August 31, 2006**	**May 31, 2006**	**February 28, 2006**	**November 30, 2005**	**August 31, 2005**	**May 31, 2005**	**February 28, 2005**
	(unaudited)							
	(U.S. dollars in thousands)							
Revenues	$ 241,096	$ 263,138	$ 288,882	$ 190,517	$ 203,564	$ 163,918	$ 169,604	$ 142,523,
Cost of revenues non-cash equity compensation	280	282	253	108				
Cost of revenues other	198,778	207,206	226,600	152,840	159,334	130,788	132,353	112,840
Gross profit	42,038	55,650	62,029	37,569	44,230	33,130	37,251	29,683
Operating expenses:								