

XYRATEX LTD  
Form 20-F  
February 20, 2007

**XYRATEX LTD**

**ANNUAL REPORT FOR THE YEAR ENDED**

**NOVEMBER 30, 2006**

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

# UNITED STATES

# SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

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## Form 20-F

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

or

- 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

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

or

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

(Commission file number 000-50799)

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## 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)

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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:

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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

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

Yes  No

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  No

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  No

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

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

Item 17  Item 18

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  No

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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 subsidiaries refer to 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* and other similar words and phrases used in this Annual Report, 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 those 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.

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	Year Ended November 30,				
	2006	2005	2004	2003	2002
	(U.S. dollars in thousands)				
<b>Consolidated Statement of Operations Data:</b>					
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

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- (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)				
<b>Consolidated Balance Sheet Data:</b>					
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
<b>Number of shares issued and outstanding:</b>					
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.***

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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

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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 difficulty 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.

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\* 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





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.**

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**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)			
<b>Revenues:</b>				
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
<b>Gross profit:</b>				
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
<b>Operating expenses:</b>				
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 believes 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.

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*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)			
<b>Revenues:</b>				
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
<b>Gross profit:</b>				
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
<b>Operating expenses:</b>				
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.

	<b>Three Months Ended</b>		<b>May 31,</b>	<b>February 28,</b>	<b>November 30,</b>	<b>August 31,</b>	<b>May 31,</b>	<b>February 28,</b>
	<b>November 30,</b>	<b>August 31,</b>	<b>2006</b>	<b>2006</b>	<b>2005</b>	<b>2005</b>	<b>2005</b>	<b>2005</b>
	<b>2006</b>							
	<b>(unaudited)</b>							
	<b>(U.S. dollars in thousands)</b>							
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:								
Research and development development arrangement								
Research and development non-cash equity compensation	557	586	534	285				
Research and development other	16,909	17,475	18,868	16,177	16,845	14,062	12,858	10,562
Selling, general and administrative non-cash equity compensation	981	1,184	1,168	976	207	240	191	190
Selling, general and administrative other	14,886	14,580	14,787	11,892	11,531	9,164	8,914	8,405
Amortization of intangible assets	1,430	1,318	1,185	1,185	1,658	834	328	398
In-process research and development					1,000		2,230	
Other costs								
Total operating expenses	34,763	35,143	36,542	30,515	31,241	24,300	24,521	19,555
Operating income	7,275	20,507	25,487	7,054	12,989	8,830	12,730	10,128
Other income (expense), net	1,202		1,965					
Interest income net	295	429	233	205	156	351	320	349
Income before income taxes	8,772	20,936	27,685	7,259	13,145	9,181	13,050	10,477
Provision (benefit) for income taxes	(582 )	3,125	3,109	822	(394 )	1,324	2,000	1,034
Net income from continuing operations	9,354	17,811	24,576	6,437	13,539	7,857	11,050	9,443



Our operating results have varied on a quarterly basis during our history. We expect to experience significant fluctuations in our future operating results due to a variety of factors, many of which we do not control. Factors that may affect our operating results include: the loss of significant customers; the size, timing and fluctuations of customer orders; the timing and market acceptance of product introductions or enhancements; increased competition and negative pricing pressures; and growth of the market for data communication networks.

For a more detailed discussion of the factors that may affect our revenues, operating results and the market price of our common shares, see Part I, Item 3D Risk Factors .

### **Liquidity and Capital Resources**

We have financed our operations since our management buy-out in 1994 primarily through cash flow from operations, sales of non-core businesses and bank borrowings. In our 2004 fiscal year we also received the net proceeds from our initial public offering.

#### *Cash flows*

Net cash provided by operating activities was \$54.5 million, \$38.6 million and \$22.8 million for our fiscal years ended November 30, 2006, 2005 and 2004 respectively.

Operating cash flows in these fiscal years have been affected by underlying revenue growth. This, together with the related increases in cost of sales and operating expenses, has resulted in an increased requirement for working capital. In particular, as described in the discussion below, this has resulted in operating cash out flows related to increases in accounts receivable and inventories partly offset by increases in accounts payable.

As described in the discussion of the results of continuing operations for our 2004 fiscal year, in August 2004 a \$6.0 million supplier note receivable was repaid together with accrued interest of \$1.1 million. The loan had been recorded as an expense in our 2002 fiscal year and this expense was reversed in the first quarter of our 2004 fiscal year. The reversal of the expense has been included as an adjustment to operating cash flows and the subsequent repayment of the loan has been included as an investing cash inflow.

Cash provided by operating activities of \$54.5 million for the 2006 fiscal year resulted primarily from the positive contribution of net income of \$58.2 million after excluding net non-cash charges totaling \$22.7 million together with increases in current liabilities of \$9.3 million. The increase in current liabilities resulted primarily from the increase in revenues. A decrease in deferred income taxes of \$5.8 million, related primarily to the usage of U.K. net operating loss carry-forwards, also contributed to operating cash flow. These positive effects on cash flows were partially offset by increases in accounts receivable and inventories of \$21.1 million and \$21.5 million, respectively. The increase in inventories results from an increase in the levels of revenue and changes to installation schedules by our disk drive manufacturer customers. The increase in accounts receivable resulted from an increase in revenues.

Cash provided by operating activities of \$38.6 million for our 2005 fiscal year resulted primarily from the positive contribution of net income of \$41.9 million after excluding non-cash charges totaling \$14.2 million together with an increase in accounts payable of \$25.7 million. A decrease in deferred income taxes of \$4.4 million and an increase in employee compensation and benefits payable of \$2.5 million also contributed to the cash provided by operating activities. The increases in accounts payable and employee compensation and benefits payable result primarily from underlying revenue growth. The decrease in deferred income tax assets related primarily to the usage of U.K. net operating loss carryforwards. These positive effects on cash flows were partially offset by increases in accounts receivable and inventories of \$29.3 million and \$16.3 million, respectively, resulting primarily from revenue

growth. In addition a \$2.6 million decrease in deferred revenue also offset the increase in cash provided by operating activities. The increase in deferred revenue resulted primarily from a decrease in orders on hand for Storage Infrastructure products where payments are made in advance of shipment.

Cash provided by operating activities for our 2004 fiscal year resulted primarily from net loss from continuing operations after excluding non-cash items of \$168.1 million for equity compensation, \$6.0 million for the supplier note receivable and \$6.5 million for depreciation and amortization. Increases in accounts payable and other accrued liabilities of \$4.3 million and \$1.2 million, respectively, resulting primarily from growth in the business also contributed to cash provided by operating activities. These positive effects on cash flows were partially offset by increases in accounts receivable, inventories and deferred income taxes of \$6.7 million, \$2.1 million and \$7.7 million respectively and decreases in employee compensation and benefits payable and deferred revenue of \$1.6 million and \$11.1 million respectively. The increases in accounts receivable and inventories resulted primarily from underlying sales growth. The increase in deferred income taxes resulted primarily from the recording of a \$12.3 million deferred tax asset arising from the tax benefit relating to share options granted to our UK employees partially offset by the usage of U.K. net operating loss carryforwards. The decrease in employee compensation and benefits payable resulted primarily from 2004 fiscal year bonuses being lower than 2003 fiscal year bonuses. The decrease in deferred revenue resulted from a change in payment terms with a major customer where certain payments were no longer made in advance of shipment together with a reduction in orders on hand from that customer.

Net cash used in investing activities was \$35.4 million for our 2006 fiscal year, \$51.9 million for our 2005 fiscal year and \$10.4 million for our 2004 fiscal year.

Net cash used in investing activities for the 2006 fiscal year included \$9.8 million deferred consideration related to our acquisition of ZT Automation in 2004, \$1.7 million consideration relating to our acquisition of Jastam Trading Co. Limited on September 4, 2006, \$19.9 million related to capital expenditure and \$4.0 million related to the acquisition of a portfolio of patents from IBM on June 30, 2006.

Our capital expenditures relate primarily to purchases of equipment such as tooling, production lines and test equipment. In addition, in July 2005 we commenced a new project to replace our Enterprise and Resource Planning ( ERP ) system. This will result in additional capital expenditure of approximately \$9.0 million in our 2005, 2006 and 2007 fiscal years, of which \$3.8 million and \$3.0 million, respectively is included in capital expenditure in our 2005 and 2006 fiscal years. With this exception, we do not anticipate any significant changes in the nature or level of our capital expenditures and we would expect these to generally change in line with our revenues. With the exception of the new ERP system, we currently have no material commitments for capital expenditures.

Net cash used in investing activities for our 2005 fiscal year comprised \$24.5 million consideration for our acquisition of nStor, \$14.2 million initial consideration for our acquisition of Oliver Design less cash acquired of \$10.3 million, \$4.3 million deferred consideration related to our acquisition of ZT Automation, \$2.2 million for our purchase of partially developed intellectual property from Cap Epsilon and \$17.1 million related to capital expenditure.

Net cash used in investing activities for our 2004 fiscal year comprised \$6.0 million in respect of the initial consideration for the acquisition of the business of ZT Automation LLC, \$1.4 million in respect of the purchase of intellectual property from Beyond3 and \$9.0 million related to capital expenditure, partially offset by a \$6.0 million repayment of a supplier note receivable. Further payments of up to \$17.2 million may be made for the Beyond3 intellectual property of which \$1.2 million is based on the achievement of product delivery milestones and the remainder is based on a percentage of operating profit generated by the products. No additional amounts were paid or payable in connection with the Beyond 3

intellectual property as of November 30, 2006. The supplier note receivable is described in the discussion of the results of continuing operations for our 2005 fiscal year.

Net cash used in our financing activities was \$3.4 million in our 2006 fiscal year and \$9.0 million in our 2005 fiscal year. Net cash provided by our financing activities was \$49.0 million in our 2004 fiscal year.

Net cash used in financing activities for the 2006 fiscal year comprises quarterly repayments totaling \$4.0 million under our HSBC term loan and payments of \$3.0 million deferred consideration for the acquisition of Oliver Design offset by \$3.6 million proceeds from the exercise of employee share options.

Net cash used in financing activities for our 2005 fiscal year includes repayments totaling \$5.1 million of short-term borrowings assumed as part of our acquisition of nStor, the payment of a \$2.0 million acquisition note payable related to our acquisition of ZT Automation and quarterly repayments totaling \$4.0 million under our HSBC term loan. These were partially offset by proceeds of \$2.2 million from the exercise of employee share options.

Net cash provided by financing activities in our 2004 fiscal year includes the net proceeds of our initial public offering on June 29, 2004 in which we issued 4,000,000 common shares at \$14.00 per share. The total proceeds received by us were \$56.0 million and net proceeds received by us after deducting underwriting discounts and other offering expenses was \$48.1 million. In addition, \$5.0 million related to the issuance of ordinary shares to employees and directors in respect of share options and other share awards. These were partially offset by the four quarterly repayments of \$1.0 million under our HSBC term loan.

#### *Liquidity*

As of November 30, 2006, our principal sources of liquidity consisted of cash and cash equivalents of \$56.9 million and our multi-currency credit facilities with HSBC. The HSBC credit facilities include the remaining \$7.0 million of a \$19.0 million term loan. This loan is repayable in equal quarterly installments over approximately five years. The facilities also include a revolving line of credit which expires in December 2008, and a short-term overdraft facility. The revolving line of credit is for an aggregate principal amount of up to \$30.0 million and bears interest at a rate of between 0.6% and 1.25% above LIBOR, depending on the level of debt relative to operating income. The overdraft facility is for an aggregate principal amount of \$15.0 million and bears interest at a rate equal to 0.75% above LIBOR. As of November 30, 2006, we had no debt outstanding under our revolving line of credit or our overdraft facility. The HSBC credit facilities provide for a security interest on substantially all of our assets.

Our future financing requirements will depend on many factors, but are particularly affected by the rate at which our revenues and associated working capital requirements grow, changes in the payment terms with our major customers and suppliers of disk drives, and quarterly fluctuations in our revenues. Additionally, our cash flow could be significantly affected by any acquisitions we have made or might choose to make or alliances we have entered or might enter into. We believe that our cash and cash equivalents together with our credit facilities with HSBC will be sufficient to meet our cash requirements at least through the next 12 months. We cannot assure you that additional equity or debt financing will be available to us on acceptable terms or at all.

**Contractual Obligations**

The following table sets forth our contractual obligations as of November 30, 2006 that may affect our liquidity over the next five years:

	Payments due by Period				After 5 years
	Total (US dollars in thousands)	Less than 1 year	1-3 years	4-5 years	
Long-term borrowings	\$ 7,000	\$ 4,000	\$ 3,000	\$	\$
Operating lease commitments	19,708	6,643	12,514	551	
Purchase commitments	217,178	217,178			
Total contractual cash obligations	\$ 243,886	\$ 227,821	\$ 15,514	\$ 551	\$

We have no ongoing commercial commitments, such as lines of credit, guarantees or standby purchase orders that would affect our liquidity over the next five years.

In connection with our purchase of Intellectual property from Beyond3 we may be required to make payments of up to \$17.2 million of which \$1.2 million is based on the achievement of product delivery milestones and \$16.0 million is based on future operating income related to these products.

**Off Balance Sheet Arrangements**

As of November 30, 2006, we did not have any significant off-balance-sheet arrangements.

**Accounting Policies***Critical Accounting Policies*

The discussion and analysis of our financial condition and results of operations are based on our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. Note 2 of the notes to our consolidated financial statements describes our significant accounting policies and is an essential part of our consolidated financial statements. The preparation of our consolidated financial statements requires us to make estimates and assumptions that affect the reported amounts and disclosures.

We believe the following to be critical accounting policies. By critical accounting policies we mean policies that are both important to the portrayal of our financial condition and financial results and require critical management judgments and estimates about matters that are inherently uncertain. Although we believe that our judgments and estimates are appropriate, actual future results may differ from our estimates.

*Share Based Payment*

Under FAS 123R, we use the Black-Scholes option pricing model as our method of valuation for share-based awards. Our determination of the fair value of share-based awards on the date of grant using an option pricing model is affected by our share price as well as assumptions regarding a number of highly complex and subjective variables. These variables include, but are not limited to the expected life of the award, our expected share price, volatility over the term of the award, expected forfeiture levels and actual and projected exercise patterns. Although the fair value of share-based awards is determined in accordance with FAS 123R, the Black-Scholes option pricing model requires the input of highly subjective assumptions, and other reasonable assumptions could provide differing results.

### ***Inventory Reserves***

Inventories are valued at the lower of standard cost, which approximates actual cost computed on a first-in, first-out basis, or market value. We establish reserves against our inventories that are equal to the difference between the cost of inventory and its estimated market value. We are required to make estimates about future customer demand for our products, taking into account historical patterns, order backlog, changes in technology, projected sales based on economic conditions and growth prospects, and market acceptance of current and future products. A failure to correctly estimate these conditions or uncertainty in the future outlook for the economy and our industry, or other failure to estimate correctly, could result in additional inventory losses in excess of the reserves established and determined to be appropriate as of the balance sheet date.

### ***Warranty Reserves***

We record warranty reserves for the estimated cost of product warranty obligations for manufacturing defects in our products. These reserves are estimated based on expected warranty costs taking into account historical failure rates and the related warranty costs incurred. Warranty reserves are recorded as a cost of revenues and are estimated at the time of sale. While we have active programs in place to monitor the quality of products sold as well as failure rates for those products, some of our products are complex and may contain defects that are detected only after deployment in complex networks and systems. For example, we were required to make a provision of approximately \$1.0 million in the fourth quarter of our 2006 fiscal year for a specific warranty claim. If actual failure rates differ from management estimates due to a decrease in the quality or design of materials and components or a decrease in the effectiveness of our monitoring programs, actual costs may differ from the amounts covered by our reserves and therefore may affect future earnings. In the event that we can no longer reliably estimate our product warranty liabilities at the time of sale, as a result of uncertainties or otherwise, this will have a material adverse impact on our recognition of revenue and earnings in future periods.

### ***Income Taxes***

We have recorded a \$17.3 million valuation allowance against the deferred tax asset balance of \$36.6 million due to the likelihood that, based on management's judgment and assumptions, this portion of the balance will not be realized. We have considered future taxable income and ongoing prudent and feasible tax planning strategies in assessing the need for the valuation allowance. Should we determine that we will, more likely than not, be able to realize a greater or lesser proportion of our deferred tax assets in the future, whether this determination was the result of changes in our judgment, assumptions or estimates, or due to uncertainties or otherwise, an adjustment to the deferred tax assets would increase or decrease income in the period such determination was made. The deferred tax asset balance includes an amount of \$6.3 million which relates to the income tax deduction which may be obtained when employees exercise share options or Restricted Stock Units vest, calculated as the excess of the market price on the date of exercise over the exercise price. All movements in this element of the deferred tax asset have been recorded as changes in additional paid in capital since the actual tax benefits have been in excess of those initially recorded. As well as being dependent on the factors affecting future taxable income the realization of this asset is also dependent on our future share price.

### ***Intangible Assets***

We have recorded intangible assets on the acquisition of businesses and certain assets. The cost of the acquisition is allocated to the assets and liabilities acquired, including identifiable intangible assets, with the remaining amount being classified as goodwill. Goodwill and purchased intangible assets include existing workforce, existing technology, patents, customer contracts and covenants not to compete. Identifiable intangible assets are amortized over time, while in-process research and development is recorded as a charge on the date of acquisition and goodwill is capitalized, subject to periodic review for

impairment. Accordingly, the allocation of the acquisition cost to identifiable intangible assets has a significant impact on our future operating results. The allocation process requires extensive use of estimates and assumptions, including estimates of future cash flows expected to be generated by the acquired assets. Should conditions be different than management's current assessment, material write-downs of the fair value of intangible assets may be required. We periodically review the estimated remaining useful lives of our other intangible assets. A reduction in the estimate of remaining useful life could result in accelerated amortization expense or a write-down in future periods. As such, any future write-downs of these assets would adversely affect our operating results.

We evaluate the impairment of goodwill on an annual basis, or sooner if events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Triggering events for impairment reviews may be indicators such as adverse industry or economic trends, restructuring actions or lower projections of profitability. Evaluations of possible impairment and, if applicable, adjustments to carrying values, require us to estimate, among other factors, future cash flows, useful lives, and fair market values of our reporting units and assets. Actual results may vary from our expectations. Accordingly, goodwill recorded in business combinations may significantly affect our future operating results to the extent impaired, but the magnitude and timing of any such impairment is uncertain. When we conduct our annual evaluation of goodwill the fair value of goodwill is re-assessed using valuation techniques that require significant management judgment. Should conditions be different than management's last assessment, significant write-downs of goodwill may be required.

Intangible assets as of November 30, 2006 were \$58.1 million, and any future write-downs of goodwill would adversely affect our operating margin.

#### ***Recent Accounting Pronouncements***

In May 2005, the FASB issued FAS No. 154, *Accounting Changes and Error Corrections* ( FAS 154 ), which replaced APB No. 20, *Accounting Changes* and FAS No. 3, *Reporting Accounting Changes in Interim Financial Statements* . FAS 154 changes the requirements for the accounting for and reporting of a change in accounting principle by requiring voluntary changes in accounting principles to be reported using retrospective application, unless impractical to do so. FAS 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005.

In June 2005, the FASB issued Staff Position FAS 143-1, *Accounting for Electronic Equipment Waste Obligations* ( FSP 143-1 ), which provides guidance on the accounting for certain obligations associated with the Waste Electrical and Electronic Equipment Directive (the Directive ), adopted by the European Union ( EU ). Under the Directive, the waste management obligation for historical equipment remains with the commercial user until the customer replaces the equipment. FSP 143-1 is required to be applied to the later of the first reporting period ending after June 8, 2005 or the date of the Directive's adoption into law by the applicable EU member countries in which the manufacturers have significant operations. Adoption of this standard is not expected to have a material impact on our financial position or results of operations.

In July 2006, the FASB issued Interpretation No. 48 ( FIN 48 ), *Accounting for Uncertainty in Income Taxes* an interpretation of FAS No. 109 . FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an entity's financial statements in accordance with FAS No. 109 and prescribes a recognition threshold and measurement attribute for financial statement disclosure of tax positions taken or expected to be taken on a tax return. Additionally, FIN 48 provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006, with early adoption permitted. We will adopt FIN 48 in our 2008 fiscal year and are currently evaluating the effect FIN 48 will have on our consolidated financial position or results of operations.

In September 2006, the FASB issued FAS No. 157, Fair Value Measurements ( FAS 157 ). FAS 157 defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. FAS 157 is effective for our 2008 fiscal year. We are in the process of assessing the effect FAS 157 may have on our consolidated financial statements.

## ITEM 6: DIRECTORS, SENIOR MANAGEMENT AND EMPLOYEES

### Item 6A: Directors and Senior Management

#### *Management*

The following table sets forth certain information regarding the executive officers of Xyratex Ltd:

Name	Age	Position
Steve Barber	46	Chief Executive Officer
Richard Pearce	36	Chief Financial Officer
Steve Thompson	53	Chief Technology Officer
Adam Wray	39	Executive Vice President
Todd Gresham	46	Executive Vice President

*Steve Barber* is our Chief Executive Officer and a member of our Board of Directors. Mr. Barber has served as Chief Executive Officer of Xyratex Ltd and its predecessor companies since February 2003, having previously served as President from March 2002 and as Executive Vice President and Director of Business Development from October 2000. Prior to assuming these positions, Mr. Barber led the development of our warranty and repair business from a small U.K. based company to a global business with operations in Europe, the United States and Southeast Asia. Our warranty and repair business was sold to Teleplan in June 1999. Mr. Barber acted as a division president of Teleplan from June 1999 before leaving Teleplan and re-joining our business in October 2000. Mr. Barber was a member of the executive team that led our 1994 management buy-out from IBM and, prior to that, held a number of management positions with IBM. Mr. Barber holds a Bachelor of Science degree in electronic engineering from the University of Natal, Durban, South Africa. Mr. Barber also serves as a director on the boards of directors of several of our subsidiaries.

*Richard Pearce* is our Chief Financial Officer. Mr. Pearce has served as Chief Financial Officer of Xyratex Ltd and its predecessor companies since September 2003 and previously served as Treasurer and as Group Tax Manager following our management buy-out from IBM in 1994. Mr. Pearce has played a significant role in material acquisition, divestiture and financing activities. Prior to joining Xyratex Ltd, Mr. Pearce held a number of financial positions within IBM over a period of six years. Mr. Pearce is a member of the Chartered Institute of Management Accountants. Mr. Pearce also serves as a director on the boards of directors of several of our subsidiaries.

*Steve Thompson* is our Chief Technology Officer. Mr. Thompson has served as Chief Technology Officer of Xyratex Ltd and its predecessor companies since December 1999. Mr. Thompson has held several senior management positions within our company and was responsible for the initial business development of our Networked Storage Solutions and Storage Infrastructure product lines. Mr. Thompson formerly worked for IBM, where he gained extensive experience in engineering and operational management in the United Kingdom and Japan, and, prior to that, for GEC Telecommunications. Mr. Thompson has a degree from Swansea University in computer technology.

*Adam Wray* is our Executive Vice President of Storage Infrastructure. Mr. Wray has served as Executive Vice President of our Storage Infrastructure business since December 2001. Prior to this time, Mr. Wray served in several business management and engineering positions within our Storage Infrastructure business. In his 20 years of experience in the disk drive industry, Mr. Wray has held a variety of engineering and management appointments both at our company and at IBM. Over this time period, he





has also spent two years in the IBM advanced manufacturing group in Japan, and one and a half years in Irvine, California in key customer account management and engineering management roles. Mr. Wray holds a Bachelor of Engineering degree from the Special Engineering Programme, Brunel University, London.

*Todd Gresham* is our Executive Vice President of Networked Storage Solutions. Mr. Gresham previously served as a Senior Vice President in our Networked Storage Solutions division. There, he led Sales, Marketing and Support, since September 2005, when he joined Xyratex from nStor Technologies, Inc. At nStor, he was President and CEO. Mr. Gresham brings over 25 years of executive management experience in both publicly traded and privately held companies. Mr. Gresham served as Vice President of Global OEM and Reseller Sales at EMC, and General Manager of Asia/Pacific Operations, as well as Vice President of Worldwide Sales at CLARiiON. Prior to CLARiiON, Mr. Gresham held various executive positions with both Philips Laser Magnetics (LMSI), a division of Philips NV, and StorageTek. Mr. Gresham serves on the Board of Directors for Glasshouse Technologies, a privately held storage services consulting organization.

#### ***Board of Directors***

The following table sets forth certain information regarding the directors of Xyratex Ltd:

<b>Name</b>	<b>Age</b>	<b>Position</b>
Andrew Sukawaty	51	Chairman
Steve Barber	46	Director
Nic Humphries	39	Director
Jonathan Brooks	51	Director
Ernest Sampias	55	Director
Steve Sanghi	51	Director

*Andrew Sukawaty* has been the Chairman of our board of directors since October 2004. Mr. Sukawaty is also chairman of the board of directors and chief executive officer of Inmarsat plc, a company listed on the London Stock Exchange (LSE), the world-wide mobile satellite services provider. He is a director of O2 plc (a Telefónica S.A. subsidiary) and he is a director of Powerwave Technologies Inc (NASDAQ). He has 28 years of experience in technology industries in the United States and Europe, having previously held the offices of chief executive and president of Sprint PCS, chief executive officer of NTL, and senior roles with US West and AT&T. Mr. Sukawaty holds a BBA from the University of Wisconsin and an MBA from the University of Minnesota.

*Steve Barber.* As above.

*Nic Humphries* will be standing down as a director at this year's AGM. He has served as a member of the board directors of Xyratex Ltd and its predecessor company, Xyratex Group Limited, since September 2003. Mr. Humphries was appointed as a director by Xtx Limited, the company through which funds managed by HgCapital own our shares. Mr. Humphries is a general partner of HgCapital, a European private equity investment firm, and has been Head of HgCapital's Technology Practice since July 2001. Prior to joining HgCapital, Mr. Humphries was Managing Director of the European business of Geocapital Partners, a technology venture capital firm, and Head of Technology and Telecoms at Barclays Private Equity. He has 16 years of experience in the venture capital and private equity industry and is a member of the boards of directors of several private technology companies. Mr. Humphries holds a Bachelor of Science degree in Electronic and Electrical Engineering from the University of Salford, was a U.K. National Engineering Scholar and is a Fellow of the Association of Chartered Certified Accountants.

*Jonathan Brooks* has served as a director on our board of directors since May 1, 2004. For the past five years, Mr. Brooks has assisted several venture capital-backed private equity companies in financial and



strategic management. Mr. Brooks is currently a director of Frontier Silicon Holdings Limited, a company which supplies semiconductor technology for use in digital radio and television applications, and is Chairman of Picochip Inc., a private equity backed company developing semiconductor solutions for Wimax applications. He is also a director of e2v Technologies plc, which develops sensor technology, and Glotel Plc, a temporary staffing company, both of which are listed on the LSE. Between 1995 and 2002, Mr. Brooks was Chief Financial Officer and a director of ARM Holdings plc, a company which listed on the LSE and NASDAQ National Market in 1998. Prior to this, Mr. Brooks performed a variety of financial roles for the Accor Group S.A. in London and Paris. Mr. Brooks holds a Bachelors degree in economic and social science from the University of Wales and an MBA from the University of Manchester and is a member of the Chartered Institute of Management Accountants.

*Ernest Sampias* has served as a director on our board of directors since May 1, 2004. In May 2006 he was appointed as Executive Vice President and Chief Financial Officer of SpectraLink Corporation in Boulder, Colorado. Mr. Sampias has over 25 years of related experience in financial management roles which include the Chief Financial Officer Role for Local Matters, Inc. and McDATA Corporation. He also has 15 years of experience in several financial management positions with US West. Mr. Sampias last assignment for US West was as Vice President and Chief Financial Officer for US West DEX, which was the Yellow Pages Directory subsidiary of US West. Mr. Sampias also has financial management experience with Convergent Communications, Inc., Aerojet-General Corporation, and Nimbus, Inc. Mr. Sampias graduated from Indiana University with a Bachelors of Science degree in Business with distinction. Mr. Sampias holds a Masters degree in Taxation from DePaul University in Chicago. Mr. Sampias is a Certified Public Accountant and a member of the Financial Executives International organization.

*Steve Sanghi* has served as a director on our board of directors since May 1, 2004. Mr. Sanghi currently serves as Director and President of Microchip Technology, Inc. since his appointment in August 1990, as CEO since October 1991, and as chairman of the board of directors since October 1993. Mr. Sanghi was previously the chairman of the board of Adflex Solutions, and a member of the board of directors of both Artisoft and Vivid Semiconductor. Mr. Sanghi worked for Intel Corporation from 1978 to 1988 in various engineering and management positions, including General Manager of Intel's programmable memory operation. Mr. Sanghi received a Bachelor of Science in Electronics and Electrical Communications Engineering from Punjab Engineering College in India in 1975 and holds a Masters degree in Electrical and Computer Engineering from the University of Massachusetts in Amherst, Massachusetts.

Our directors may be reached at the address of our San Jose facility in the United States or at our headquarters in Havant in the United Kingdom.

## **Item 6B: Compensation**

### **Director Compensation**

We paid our board of directors (consisting of 6 persons) an aggregate amount of \$945,000 for the fiscal year ending November 30, 2006 (of which \$781,000 comprised salaries or fees, \$23,000 comprised non-cash payments and \$141,000 comprised bonus payments). In addition, during our fiscal year ended November 30, 2006, we have also awarded four members of our board of directors 40,500 restricted stock units in respect of Xyratex Ltd common shares.

Our Compensation Committee, composed entirely of independent directors, determines the remuneration of our directors. We also reimburse directors for reasonable expenses incurred in attending meetings of the board, meetings of committees of the board and our general meetings. No compensation, save reasonable expenses incurred, will be paid to executive directors in respect of their role as a director.

## **Executive Compensation**

The aggregate compensation paid to the five executive officers of Xyratex Ltd for the fiscal year ending November 30, 2006 was \$1,984,000 (of which \$1,389,000 comprised salary, \$85,000 comprised non-cash payments and \$510,000 comprised bonus payments). In addition, during our fiscal year ended November 30, 2006, in aggregate we have also awarded five executive officers 75,000 restricted stock units (RSUs) in respect of Xyratex Ltd common shares of which 16,875 became eligible vesting RSUs on February 1, 2007, based on performance criteria.

At the end of our 2006 fiscal year, bonus amounts to be paid to respective executive officers were determined on a discretionary basis by the board of directors based on the satisfaction of certain performance criteria by the individual executive officer. Non-cash payments to executive officers consisted of leased cars and health insurance.

## **Item 6C: Board Practices**

### **Board Practices**

Our board of directors currently consists of six members of which a majority are independent directors. All directors hold office until their successors have been elected and qualified or until their earlier death, resignation, disqualification or removal. The terms of office of the directors is divided into three classes:

- Class I, whose term will expire at the annual general meeting to be held in 2007;
- Class II, whose term will expire at the annual general meeting to be held in 2009; and
- Class III, whose term will expire at the annual general meeting to be held in 2008.

Class I consists of Andrew Sukawaty and Ernest Sampias; Class II consists of Steve Barber and Jonathan Brooks; and Class III consists of Steve Sanghi and Nic Humphries. At each annual general meeting after the initial classification or special meeting in lieu thereof, the successors to directors whose terms expire will then serve from the time of election until the third annual meeting following election or special meeting held in lieu thereof. In addition, a resolution of the board of directors may change the authorized number of directors within the upper and lower limits set out in our bye-laws. Any additional directorships resulting from an increase in the number of directors will be distributed among the three classes so that, as nearly as possible, each class will consist of one-third of the directors. This classification of the board of directors may have the effect of delaying or preventing changes in control or management of our company.

The employment contracts governing the service of our directors do not provide for benefits upon termination of employment. There are no family relationships among any of our directors, executive officers or key employees.

### **Board Committees**

Our bye-laws give our board of directors the authority to delegate its powers to a committee appointed by the board. Committees may consist partly or entirely of non-directors, except for the audit committee, nominations and governance committee and compensation committee, which must consist only of independent directors. Our committees are required to conduct meetings and take action in accordance with the directions of the board and the provisions of our bye-laws or the written charters establishing these committees.

*Compensation Committee*

Our Compensation Committee consists of Andrew Sukawaty, Jonathan Brooks and Steve Sanghi, each of whom satisfy the independence requirements of the Nasdaq Corporate Governance Rules. The Compensation Committee determines the remuneration policy as well as the terms and conditions of service and the cessation of service of our directors and executive officers, and evaluates the compensation plans, policies and programs of the Company to encourage high performance, promote accountability and insure that employee interests are aligned with the interests of the Company's shareholders. Members of the Compensation Committee do not participate in decisions regarding their own remuneration. The Compensation Committee met four times during the fiscal year ended November 30, 2006. Its members are not eligible for bonuses or pension entitlements. The committee has access to the services of independent advisors as it requires.

*Audit Committee*

Our Audit Committee consists of Ernest Sampias, Jonathan Brooks and Steve Sanghi, each of whom satisfy the independence requirements of the Nasdaq Corporate Governance Rules. The Audit Committee met nine times during the fiscal year ended November 30, 2006. The Audit Committee is required to meet at least once during each fiscal quarter. The Audit Committee's responsibilities include:

- selecting the independent auditors and pre-approving all auditing and non-auditing services permitted to be performed by the independent auditors;
- reviewing and approving all proposed related-party transactions;
- discussing the annual audited financial statements with management and the independent auditors;
- reviewing the effectiveness of internal control over financial reporting;
- annually reviewing and reassessing the adequacy of our audit committee charter;
- meeting separately and periodically with management and the independent auditors;
- such other matters that are specifically delegated to our audit committee by our board of directors from time to time; and
- reporting regularly to the full board of directors.

In addition, the Audit Committee has approved detailed procedures regarding up the ladder reporting of violations of U.S. securities laws and procedures in an effort to ensure compliance with the provisions of the Sarbanes-Oxley Act of 2002 regarding auditor objectivity and independence.

*Nominations and Governance Committee*

Our Nominations and Governance Committee's functions include identifying and selecting qualified candidates for Board membership and ensuring compliance with applicable corporate governance requirements. The Nominations and Governance Committee is comprised of Andrew Sukawaty, Ernest Sampias and Steve Sanghi, each of whom satisfy the independence requirements of the Nasdaq Corporate Governance Rules. The Nomination and Governance Committee met twice during the fiscal year ended November 30, 2006 in connection with the reappointment of directors retiring by rotation and the selection procedures for filling the vacancy arising on the resignation of Nic Humphries.

**Item 6D: Employees**

As of November 30, 2006, we employed 1,557 permanent employees worldwide and an additional 348 temporary employees. We consider our highly qualified and motivated employees to be a key factor in our business success. Our future success will depend on our continued ability to attract, retain and motivate highly qualified engineering personnel, for whom competition is intense. Our employees are not



represented by any collective bargaining organization and we have never experienced a work stoppage. We believe that our relations with our employees are good.

The following table shows the number of employees as of the dates indicated:

	2006	2005	2004
Operations	759	747	443
Research and development	401	386	313
Sales, marketing and service	234	140	107
General and administration	163	132	105
Total	1,557	1,405	968
Total employees in the United States	548	497	234
Total employees in Asia	489	404	249
Total employees in the United Kingdom	520	502	485

## Item 6E: Share Ownership

### Executive Officer and Director Restricted Stock Units, Share Option and Share Ownership

The following table sets forth the number of our common shares and the number of options to purchase our common shares owned by our executive officers and directors as of November 30, 2006. The table also sets forth the number of our common shares owned by all of our directors and executive officers as a group.

Name	Number of Shares	Percentage of Shares Outstanding	Restricted Stock Units	Options		Expiration Date
				Number(1)	Exercise Price Per Share	
Steve Barber	705,379	2.44 %	30,000	31,091	£1.447	March 29, 2011
				72,546	£1.447	April 22, 2012
				100,000	\$14.31	January 9, 2015
Richard Pearce	134,145	0.46 %	15,000	4,318	£1.447	March 29, 2011
				51,818	£2.653	July 22, 2012
				55,000	\$14.31	January 9, 2015
Steve Thompson	174,130	0.60 %	15,000	44,566	£1.447	March 29, 2011
				50,000	\$14.31	January 9, 2015
Adam Wray	88,357	0.31 %	15,000	34,545	£1.447	March 29, 2011
				34,090	£2.653	November 13, 2011
				72,546	£2.653	July 22, 2012
				45,000	\$14.31	January 9, 2015
Todd Gresham			66,667	50,000	\$13.51	October 31, 2015
Andrew Sukawaty	107,275	0.37 %		228,003	\$14.47	March 30, 2014
Jonathan Brooks			3,500	20,000	\$14.00	June 28, 2014
				5,000	\$14.31	January 9, 2015
Ernest Sampias	2,500	0.01 %	3,500	10,000	\$14.00	June 28, 2014
Steve Sanghi			3,500	10,000	\$14.00	June 28, 2014
Nic Humphries						
All our directors and executive officers as a group (ten persons)	1,211,786	4.19 %				

(1) All options entitle the option holder to purchase one common share for each option held.

## Employee Equity Incentive Awards

Xyratex operates a range of equity incentive schemes, covering share option plans, share purchase plans, restricted stock units and restricted stock awards. With the approval of the 2006 Incentive Award Plan, we have the following types of scheme also available, namely incentive stock options and nonqualified stock options, stock appreciation rights, performance shares, performance stock units, dividend equivalents, stock payments, deferred stock, performance bonus awards and performance based awards.

Details of the schemes under which there have been transactions are given below.

Xyratex Ltd and Credit Suisse First Boston, the managing underwriter for our initial public offering in June 2004, have agreed to impose a limit on the number of our common shares over which awards resulting from the equity incentive schemes may be granted, to the effect that the total number of our common shares over which options may be granted under all our share option, share purchase, restricted stock and stock bonus award plans shall not, in any consecutive ten year period, commencing after our initial public offering, exceed 5,632,648 of our common shares (or 20% of our common shares in issue immediately following the date of our initial public offering). Lapsed and surrendered options are disregarded for these purposes. At January 31, 2007, awards over 2,043,000 of our common shares had been granted since our initial public offering.

### *The Xyratex Ltd Approved Company Share Option Plan*

The Xyratex Ltd Approved Plan is a United Kingdom share option plan which is approved by the U.K. tax authority. A U.K. tax authority approved share option plan offers tax advantages to option holders who exercise options in accordance with the provisions of the relevant legislation.

Any employee or any full time director of the Group is eligible to participate (a Participant). Actual participation is at the discretion of the board of directors of Xyratex Ltd. Options are personal to the Participant and may not be assigned. Options shall be granted by deed for no consideration.

The aggregate subscription price of all outstanding options granted to any one Participant under the Xyratex Ltd Approved Plan and under any other U.K. tax authority approved discretionary share option scheme adopted or operated by the Company may not exceed £30,000.

Our board of directors will determine the option vesting period at the time options are granted. Where employment ceases due to death, injury, disability, redundancy, the Participant's retirement at normal retirement age, or on the Participant's employing company or business ceasing to be within Xyratex Ltd's group of companies or, at the discretion of our board of directors, on the Participant in question leaving employment for any other reason, options will generally be exercisable to the extent vested at the date of cessation.

Options held by a Participant will lapse if the Participant ceases to be employed by Xyratex Ltd or any of its subsidiaries save to the extent that the reason for cessation is as outlined in the paragraph above.

Options may also be exercised in the event of a takeover or liquidation of Xyratex Ltd. Options may be exercised in these circumstances notwithstanding that any performance target has not been satisfied.

Our board of directors may impose objective conditions as to the performance of Xyratex Ltd (which must be set having regard to institutional guidelines) which must normally be satisfied before options can be exercised. Having granted options and set a performance target, our board of directors can vary the performance target provided that our board of directors reasonably considers that the original performance target set no longer represents a fair measure of performance and provided that any new target is no more difficult nor easy to satisfy. Any performance targets imposed by our board of directors will be notified to shareholders through our Annual Report.



At December 31, 2006, no performance targets have been imposed in respect of options granted under the Approved Plan.

The exercise price will be the higher of the nominal value of a Xyratex Ltd common share on the date of grant of the option and the average on market quotation of our common shares for the three dealing days immediately prior to the date on which the option is granted.

Xyratex Ltd's common shares allotted under each plan rank *pari passu* with Xyratex Ltd's existing issued Xyratex Ltd common shares (save that they will not qualify for any dividends or other distributions by reference to a record date prior to the options exercise). Participants will be required to indemnify their employing company in respect of any income tax collected through the withholding tax arrangements operating in the United Kingdom and to accept the transfer of national insurance contributions, or NICs, including employers' NICs arising in connection with the exercise of the options.

In the event of the takeover, amalgamation or reconstruction of Xyratex Ltd, options may, with the agreement of the acquiring company, be exchanged for options over shares in the acquiring company or a company associated with the acquiring company.

In the event of a variation of share capital by way of capitalization, rights issue, sub-division, consolidation or reduction of share capital, then the number of Xyratex Ltd common shares subject to a subsisting option and the price payable on exercise may be adjusted. No adjustment can be made to options granted under the Xyratex Ltd Approved Plan without prior Inland Revenue approval and no adjustment can be made which would cause the aggregate amount payable on the exercise of an option in full to be increased.

Our board of directors may alter the plans, but no alteration will have effect under the Xyratex Ltd Approved Plan without prior U.K. tax authority approval. Certain alterations cannot take effect without shareholder approval (unless they are amendments to comply with or take account of applicable legislation or statutory regulations or any change therein or any requirements of the Inland Revenue for the approval of the Xyratex Ltd Approved Plan or to obtain or maintain favorable taxation treatment for Xyratex Ltd or Participants or potential Participants), being the limits on the number of Xyratex Ltd common shares which can be offered under the relevant plans, the category of persons who may participate, the price at which options may be granted, the number of Xyratex Ltd common shares over which an employee may hold an option, the period during which options may be offered and exercised, the rights attaching to Xyratex Ltd common shares subject to an option, the provisions for altering the rights attaching to common shares and for altering the terms of the relevant plan and the provisions which apply on a winding-up of Xyratex Ltd.

None of the benefits which may be received under the Xyratex Ltd Approved Plan shall be pensionable.

#### *The Xyratex Ltd Unapproved Company Share Option Plan*

The Xyratex Ltd Unapproved Company Share Option Plan has the same features as the Xyratex Ltd Approved Company Share Option Plan except that (i) the £30,000 individual participation limit does not apply to options granted under the Xyratex Ltd Unapproved Company Share Option Plan; and (ii) the requirements for U.K. tax authority approval or consent do not apply.

#### *The Xyratex Sharesave Plan*

The Sharesave Plan is a U.K. tax authority approved employee share purchase plan where eligible employees who elect to participate will receive options on favorable terms to purchase our shares with U.K. tax advantages.

Any U.K. employee or full-time director is eligible to participate. Invitations to join the Sharesave Plan are made at the Company's discretion. Each participant who enrolls in the Sharesave Plan will receive an option to purchase shares at a maximum 20% discount to the market price on joining the plan at the end of a three year term. During this period accumulated payroll deductions of the participant will be paid into a savings account operated by Yorkshire Building Society. At the end of the savings term, the participant can choose to use their savings to buy shares in Xyratex Ltd at the option price, or withdraw their savings from the plan with a guaranteed tax-free bonus.

The maximum amount that any participant may save per month under the plan is £250, which must be determined and fixed on enrollment in the plan.

In the event of a variation of share capital by way of capitalization, rights issue, sub-division, consolidation or reduction of share capital, then the number of Xyratex Ltd common shares subject to a subsisting option and the price payable on exercise may be adjusted. No adjustment can be made to options granted under the Sharesave Plan without prior Inland Revenue approval.

Our board of directors may alter the plans, but no alteration will have effect under the Sharesave Plan without prior U.K. tax authority approval. The provisions relating to shareholder approval for amendments are as the Xyratex Ltd Approved Plan.

None of the benefits which may be received under the Sharesave Plan shall be pensionable.

The Sharesave Plan was approved by our shareholders at our annual general meeting of shareholders on April 13, 2005.

#### *The Xyratex Ltd 2004 Stock Option Plan*

The 2004 Plan is a U.S. stock option plan under which we may grant incentive stock options to purchase our shares to our employees and nonqualified stock options to purchase our shares to our employees, consultants and non-employee officers and directors.

The per share exercise price of an incentive stock option may not be less than the fair market value of one of our common shares on the date of grant (and not less than 110% of the fair market value in the case of incentive stock options granted to holders of our shares possessing more than 10% of the voting power of all classes of our then outstanding shares). Initially, the per share exercise price of a nonqualified stock option will not be restricted, but all nonqualified stock options granted after a specified period and for so long as Xyratex Ltd is a publicly held corporation will be required to have a per share exercise price of not less than the fair market value of our common shares on the date of grant. An option may not be exercised more than ten years after the date of grant. Under the 2004 Plan, an option granted to an employee, consultant, officer or director will terminate if employment or service terminates. The maximum number of shares we can issue under the 2004 Plan is 5,000,000, provided that the limits set forth above in Employee Equity Incentive Awards shall apply.

Under the 2004 Plan, if any of certain specified types of transactions occurs, for example if we amalgamate with another entity, then, depending on the transaction, we may or will be required to (i) arrange for the substitution of options on equity securities other than our common shares in exchange for outstanding options, (ii) accelerate the vesting and termination of outstanding options, in whole or in part, or (iii) cancel outstanding options in exchange for cash payments.

#### *The Xyratex Ltd 2004 Employee Stock Purchase Plan*

The Employee Stock Purchase Plan, or ESPP, is a U.S. employee stock purchase plan under which eligible employees of any of our designated subsidiaries who elect to participate will receive rights to purchase our shares on favorable terms and with U.S. federal income tax advantages through accumulated payroll deductions.

The sole initial designated subsidiary is Xyratex International, Inc. Our board of directors may change the designated subsidiaries from time to time.

Each participant who enrolls in the ESPP for an offering period will receive a purchase right. A purchase right entitles a participant to purchase at the end of each offering period the number of our common shares determined by dividing the participant's accumulated payroll deductions in his or her plan account by the purchase price for that offering period. Generally, the per share purchase price of the shares subject to a purchase right for an offering period is 85% of the lower of the fair market value of one of our common shares on the first trading day of the offering period or the fair market value of such a share on the last trading day of the offering period. Generally, the fair market value of one of our common shares on any date will be the closing price of such a share on The NASDAQ Stock Market LLC on that date.

Any individual (except any employee who owns shares possessing 5% or more of the voting power or value of all classes of our issued shares or the shares of any of our subsidiaries) will be eligible to participate in the ESPP for an offering period if he or she both (i) was employed by a designated subsidiary throughout a specified period ending on the first trading day of such offering period, and (ii) is customarily employed, as of such day, by a designated subsidiary for at least 20 hours per week and for at least five months per calendar year.

The maximum fair market value of our common shares that any participant may purchase under the plan during any calendar year is \$25,000, determined on the first trading day of the offering period.

The initial number of our shares reserved for issuance pursuant to purchase rights to be granted under the ESPP is 100,000. On each December 1, beginning December 1, 2004, there will automatically be added to the number of shares reserved under the plan the least of (i) 500,000, (ii) 1% of the number of our common shares outstanding on that date or (iii) such other number of our common shares as our board of directors determines.

In the event of a sale of substantially all of our assets, or in the event we amalgamate with another corporation or we liquidate or dissolve, or in the event of any other transaction as a result of which other shares are substituted for our common shares or our common shares may no longer be issued, our board will provide for the assumption or substitution of purchase rights by the successor or surviving corporation or a parent or subsidiary or take such other action as it deems appropriate.

Subject to the approval of our shareholders as to certain types of amendments, our board of directors may modify, amend, alter or terminate the ESPP, including amending or terminating any or all outstanding purchase rights, at any time.

#### *The Xyratex Ltd 2004 Directors Stock Option Plan*

Xyratex Ltd adopted a 2004 Directors Stock Option Plan for the purpose of making one-time grants of options to purchase 20,000 Xyratex Ltd common shares to each of Ernest Sampias, Steve Sanghi and Jonathan Brooks. The non-qualified stock options were granted effective June 29, 2004 and the exercise price of the options is \$14.00 per share, equal to the initial public offering price of our common shares. The options will vest as to 25% of the shares on each November 30 in 2004 through 2007. An option may not be exercised after the option holder ceases to be a director of Xyratex Ltd for any reason or no reason, or more than ten years after the date of grant. The maximum number of shares we can issue under the plan is 60,000 shares.

*The Xyratex Ltd Deputy Chairman's Stock Option Plan*

Xyratex Ltd made a one-time grant of options to purchase 228,003 Xyratex Ltd common shares to Mr. Sukawaty, who at the time of grant was Deputy Chairman of the Company. The unapproved stock options were granted effective March 31, 2004 and the exercise price of the options is \$14.47 per share. The options vest as to 25% of the shares on each November 30 in 2004 through 2007. An option may not be exercised after the option holder ceases to be a director of Xyratex Ltd for any reason or no reason, or more than ten years after the date of grant. The maximum number of shares we can issue under the plan is 228,003 shares.

*Restricted Stock Units (RSUs)*

The Compensation Committee is authorized to make Awards of RSUs to any participant selected by the Committee in such amounts and subject to such terms and conditions as determined by the Committee. At the time of grant, the Committee shall specify the date or dates on which the RSUs shall become fully vested and nonforfeitable, and may specify such conditions to vesting as it deems appropriate. At the time of grant, the Committee shall specify the maturity date applicable to each grant of RSUs which shall be no earlier than the vesting date or dates of the Award and may be determined at the election of the grantee. On the maturity date, the Company shall issue to the participant one unrestricted, fully transferable share for each RSU scheduled to be paid out on such date and not previously forfeited. Members of the Board, employees and consultants are eligible to be awarded RSUs.

During our 2006 fiscal year 540,367 RSUs were granted. Of these 357,409 were eligible vesting RSUs. 93,035 fully transferable shares were issued to grantees on 1 February 2007. The number of RSUs eligible for vesting was subject to performance criteria based upon our and in certain cases individual performance. 26% of the eligible RSUs vested on 1 February 2007 and the remainder shall vest on 1 February for each of the next three years. To receive the shares on these further vesting dates the participant is required to still be an employee, director or consultant.

*Restricted Stock*

Restricted stock awards are shares of our common shares that will vest in accordance with terms and conditions established by the board of directors. The board of directors may impose whatever conditions to vesting it determines to be appropriate. For example, the board of directors may set restrictions based on the achievement of specific performance goals. Unvested shares will be subject to our right of repurchase or forfeiture.

At December 31, 2006, we had granted rights to restricted shares to new employees in connection with the purchase of intellectual property from Cap Epsilon in April 2005. We granted rights to 190,000 shares at no cost, which will vest based on the achievement of certain revenue targets over the three years ended August 31, 2008. In addition we granted rights to 5,000 restricted shares to new employees in connection with the Oliver Design acquisition.

*Stock Bonus Awards*

Stock Bonus awards consist of our common shares awarded in recognition of services rendered to Xyratex Ltd or its affiliates. The board of directors may impose whatever vesting it determines to be appropriate. Unvested shares may be subject to our right of repurchase or forfeiture.

At December 31, 2006, no stock bonus awards have been made.

*Xyratex Group Limited Share Option Plans*

Xyratex Group Limited is the predecessor holding company of the group prior to June 29, 2004. Options granted under Xyratex Group Limited's share option plans are held by employees in the United

Kingdom, Malaysia and Singapore, and are over unissued common shares and common shares held by the Trustee for the Havant International Employee Benefit Trust.

*The Unapproved Plan*

The Unapproved Plan was adopted on October 12, 2000. Under the Unapproved Plan options were granted by the Trustee of the Havant International Employee Benefit Trust. As at December 31, 2006, there are no subsisting options granted under this plan.

*The Approved Plan and Unapproved Schedule*

The Approved Plan and Unapproved Schedule were adopted on February 13, 2001. Under the Approved Plan and the Unapproved Schedule options subsist over our shares held by the Trustee of the Havant International Employee Benefit Trust and over unissued shares. The Approved Plan and Unapproved Schedule have the same features as the Xyratex Ltd Approved Plan and Xyratex Ltd Unapproved Plan respectively.

Options have not been granted by Xyratex Group Limited under the Approved Plan and the Unapproved Schedule since our initial public offering in June 2004.

The following table contains a summary of all options that have been granted under the Company's share option plans as of November 30, 2006:

Name of Plan	No. of issued shares over which the Trustee(1) has granted options(2)	No. of unissued shares over which Xyratex Ltd has granted options(3)	Total number of shares over which options have been granted
The Xyratex Ltd Approved Plan		89,605	89,605
The Xyratex Ltd Unapproved Plan		585,871	585,871
The Approved Plan	378,761	31,091	409,852
The Unapproved Schedule	65,587	323,420	389,007
The 2004 Plan		594,745	594,745
The Directors Stock Option Plan		40,000	40,000
The Deputy Chairman's Stock Option Plan		228,003	228,003

- (1) Trustee for the Havant International Employee Benefit Trust.
- (2) All options entitle the option holder to purchase one common share for each option held.
- (3) 133,135 of the unissued common shares over which Xyratex Ltd has granted options are held by The Xyratex UK Employee Benefit Trust. Xyratex Trustees Limited, as trustee for The Xyratex UK Employee Benefit Trust, has agreed to transfer these common shares to beneficiaries of the trust on the exercise of options granted by the Company over such common shares.

**ITEM 7: MAJOR SHAREHOLDERS AND RELATED PARTY TRANSACTIONS**

**Item 7A: Major Shareholders**

The table below sets forth information regarding beneficial ownership of shares of Xyratex Ltd as of the most recent practicable date held by each person who is known by us to have more than 5.0% beneficial share ownership.

As used in this table, beneficial ownership means the sole or shared power to vote or direct the voting or to dispose or direct the sale of any security. A person is deemed to be the beneficial owner of securities that can be acquired within 60 days upon the exercise of any option, warrant or right. Common shares

subject to options, warrants or rights that are currently exercisable or exercisable within 60 days are deemed outstanding for computing the ownership percentage of the person holding the options, warrants or rights, but are not deemed outstanding for computing the ownership percentage of any other person.

Shareholders Name	Date	Shareholdings of Xyratex Ltd	
		Shares	Percentage
Hg Pooled Management Ltd(1)	December 31, 2006	5,587,359	19.4 %
FMR Corp	December 31, 2006	3,993,655	13.9 %

For information on the beneficial ownership of these shares see the relevant Forms SC 13G/A as filed with the SEC on February 14, 2007.

(1) During the past three years the percentage of shares held was 55.7%, 32.2% and 27.2% as at November 30, 2003, January 31, 2005 and January 31, 2006 respectively.

The voting rights of the major shareholders are no different from all other shareholders.

As of January 31, 2007, the number of shares of Xyratex Ltd held of record in the United States was 22,946,773 common shares, held by 457 record holders, representing 79.3% of our common shares outstanding.

Xyratex Ltd is not directly or indirectly owned or controlled by another corporation, by any foreign government or by any other natural or legal person.

#### Item 7B: Related Party Transactions

We are party to several agreements with Havant International Limited. A significant number of shareholders of Havant International Limited are also shareholders of Xyratex Ltd. The agreements with Havant International Limited are summarized below.

On June 10, 2002, Havant International Limited and our subsidiary, Xyratex Technology Limited, entered into a lease agreement for our corporate headquarters in Havant, United Kingdom and for the provision of services relating to this property. Pursuant to the agreement, we leased 81,000 square feet of office and manufacturing. Subsequently we have entered into lease agreements for an additional 25,000 square feet. Under the terms of these agreements, Havant International Limited has also agreed to provide certain services relating to the property, such as property taxes, security, maintenance, property insurance, conference facilities and catering. The amount payable under these agreements in our 2006 fiscal year totaled \$3.7 million. The terms of these lease agreements were negotiated with Havant International Limited. However, we have not obtained market data to determine how the negotiated terms compare to those an unrelated party may have received. Xyratex Technology Limited also procures certain additional services from Havant International Limited such as electricity, telephones, cleaning and leasehold improvements. The prices for these services are based on cost and are negotiated at least annually. In our 2006 fiscal year the amount paid to Havant International for these services totaled \$2.5 million. We have evaluated the negotiated terms of these arrangements based on comparative market data and on that basis we believe the terms approximate those which a non-related party to Havant International Limited would have received.

A predecessor company to Xyratex Ltd established the Havant International Employee Benefit Trust, or the Trust, to facilitate the distribution of shares and options over shares to employees pursuant to certain of our share incentive arrangements. As of December 31, 2006, the Trust held 444,348 Xyratex Ltd common shares, all of which were subject to options granted to our employees. Steve Barber is a member of the board of directors of Havant International Trustees Limited, the trustee of the Trust, and is a member of our board of directors.

**Item 7C: Interest of Experts and Counsel**

Not applicable.

**ITEM 8: FINANCIAL INFORMATION**

**Item 8A: Consolidated Statements and Other Financial Information**

Audited financial statements are included at Item 18: Financial Statements .

For a discussion of our legal proceedings, please see Item 4B: Business Overview Information Legal Proceedings and for a discussion of our policy on dividend distributions, please see Item 10B: Additional Information Memorandum and Articles of Association.

**Item 8B: Significant Changes**

Not applicable.

**ITEM 9: THE OFFER AND LISTING**

**Item 9A: Offer and Listing Details**

Our common shares, par value \$0.01 per share, are listed on The NASDAQ Stock Market LLC. We conducted our initial public offering in the United States on June 29, 2004 at which time we listed our common shares on The NASDAQ Stock Market LLC. At close of business on January 31, 2007, the market price for our common shares was \$20.98.

**Annual high and low market prices**

For the year ending November 30, 2006, the annual high market price for our common shares on The NASDAQ Stock Market LLC was \$33.63 and the annual low market price was \$15.63.

**Quarterly high and low market prices**

The table below states for the four quarters of our 2006 fiscal year, high and low prices of our common shares on The NASDAQ Stock Market LLC.

Quarter 2006	NASDAQ U.S. dollar per common share	
	High	Low
First	\$ 26.70	\$ 15.63
Second	\$ 33.63	\$ 22.43
Third	\$ 29.31	\$ 18.39
Fourth	\$ 23.99	\$ 17.56

**Monthly high and low market prices**

This table states high and low sales prices for the last twelve months.

Month	NASDAQ U.S. dollar per common share	
	High	Low
January 2006	\$ 23.37	\$ 16.50
February 2006	\$ 26.70	\$ 21.81
March 2006	\$ 33.63	\$ 22.43
April 2006	\$ 33.56	\$ 28.85
May 2006	\$ 32.16	\$ 24.70
June 2006	\$ 29.31	\$ 24.15
July 2006	\$ 26.74	\$ 21.26
August 2006	\$ 23.25	\$ 18.39
September 2006	\$ 21.20	\$ 17.56
October 2006	\$ 21.36	\$ 18.60
November 2006	\$ 23.99	\$ 20.53
December 2006	\$ 23.59	\$ 21.05

**Item 9B: Plan of Distribution**

Not applicable.

**Item 9C: Markets**

Our common shares are traded on The NASDAQ Stock Market LLC under the symbol XRTX .

**Item 9D: Selling Shareholders**

Not applicable.

**Item 9E: Dilution**

Not applicable.

**Item 9F: Expenses of the Issue**

Not applicable.

**ITEM 10: ADDITIONAL INFORMATION****Item 10A: Share Capital**

Not applicable.

**Item 10B: Memorandum and Bye-Laws**

We incorporate by reference a description of our Memorandum and Bye-laws as set forth in our Annual Report on Form 20-F, File No. 000-50799, filed with the SEC on February 21, 2006.

**Item 10C: Material Contracts**

Not applicable.





#### Item 10D: Exchange Controls

We have been designated by the Bermuda Monetary Authority as a non-resident for Bermuda exchange control purposes. This designation allows us to engage in transactions in currencies other than the Bermuda dollar, and there are no restrictions on our ability to transfer funds (other than funds denominated in Bermuda dollars) in and out of Bermuda or to pay dividends to United States residents who are holders of our common shares.

The Bermuda Monetary Authority has given its consent for the issue and free transferability of our shares up to the amount of our authorized capital from time to time to and between non-residents of Bermuda for exchange control purposes, provided our shares remain listed on an appointed exchange, which includes The NASDAQ Stock Market LLC. Approvals or permissions given by the Bermuda Monetary Authority do not constitute a guarantee by the Bermuda Monetary Authority as to our performance or our creditworthiness. Accordingly, in giving the consent or permissions, the Bermuda Monetary Authority shall not be liable for the financial soundness, performance or default of our business or for the correctness of any opinions or statements expressed in this Annual Report. Certain issues and transfers of common shares involving persons deemed resident in Bermuda for exchange control purposes require the specific consent of the Bermuda Monetary Authority, although the Bermuda Monetary Authority has granted permission for the issue and transferability of up to 20% of our shares in issue from time to time to persons resident in Bermuda for exchange control purposes.

#### Item 10E: Taxation

##### United States Federal Income Tax Considerations

The following discussion is a summary of material U.S. federal income tax consequences of the purchase, ownership and disposition of our common shares by a U.S. Holder (as defined below). For the purpose of this discussion only, our common shares refers to shares of Xyratex Ltd. This summary is based on the federal income tax laws of the United States (including the Internal Revenue Code of 1986, as amended, its legislative history, existing and proposed regulations thereunder, published rulings and court decisions) as in effect on the date hereof, all of which are subject to change, possibly with retroactive effect. The discussion is not a full discussion of all tax considerations that may be relevant to a decision to purchase our common shares. The discussion addresses only U.S. Holders that purchase our common shares and hold them as capital assets and use the U.S. dollar as their functional currency. It does not deal with the U.S. federal income tax treatment of investors subject to special rules, such as grantor trusts, real estate investment trusts, regulated investment companies, banks, brokers, dealers, traders in securities or currencies, financial institutions, insurance companies, tax-exempt entities, investors liable for alternative minimum tax, holders of ten percent or more of our common shares (by vote or value, and directly or by attribution), persons holding our common shares as part of a hedging, straddle, conversion or constructive sale transaction or persons whose functional currency is not the U.S. dollar. **US Holders should consult their tax advisors about the U.S. federal, state, local and foreign tax consequences to them of an investment in our common shares.**

As used in this section, U.S. Holder means a beneficial owner of our common shares that is (i) a citizen or resident of the United States, (ii) a corporation or other entity (treated as a corporation for U.S. federal income tax purposes) organized in or under the laws of the United States or its political subdivisions, (iii) a trust subject to the control of a U.S. person and the primary supervision of a U.S. court or (iv) an estate, the income of which is subject to U.S. federal income taxation regardless of its source.

If a partnership holds our common shares, the tax treatment of a partner will generally depend upon the status of the partner and the activities of the partnership. Therefore, partners of a partnership holding our common shares should consult their tax advisor.

### *Dividends*

Subject to the passive foreign investment company rules discussed below, the gross amount of any distributions paid with respect to our common shares generally will be included in the gross income of a U.S. Holder as ordinary dividend income to the extent paid out of our earnings and profits as determined under U.S. federal income tax principles. To the extent that the amount of any distribution exceeds our earnings and profits, it will be treated as a non-taxable return of capital to the extent of the U.S. Holder's adjusted tax basis in our common shares and thereafter as capital gain. The dividends will not be eligible for the dividends-received deduction available to corporations. Dividends received by a non-corporate U.S. Holder on our common shares for taxable years of such holder before January 1, 2011 may be taxed at the lower applicable capital gains rate provided that (1) we are not a passive foreign investment company (as discussed below) for either our taxable year in which the dividend was paid or the preceding taxable year, (2) our common shares are readily tradable on an established securities market in the U.S. and (3) certain holding period requirements are met. U.S. Holders should consult their own tax advisors regarding the availability of the lower rate for dividends paid with respect to common shares. Dividends paid on our common shares will generally constitute foreign source passive income or, in the case of some U.S. Holders, foreign source financial services income. For taxable years beginning after December 31, 2006, dividends paid on our common shares will generally constitute passive category income but could, in the case of certain U.S. Holders, constitute general category income.

### *Capital Gains*

Subject to the passive foreign investment company rules discussed below, a U.S. Holder generally will recognize capital gain or loss on the sale or other disposition of our common shares equal to the difference between the amount realized and the U.S. Holder's adjusted tax basis (determined in U.S. dollars) in our common shares. Any gain or loss will generally be treated as arising from U.S. sources for foreign tax credit limitation purposes. If a U.S. Holder is an individual and the common shares being sold or otherwise disposed of have been held by that individual for more than one year, the gain recognized will be eligible for reduced rates of taxation. The deductibility of capital losses is subject to limitations.

### *Passive Foreign Investment Company*

We believe that we were not a passive foreign investment company, or PFIC, for U.S. federal income tax purposes for the taxable year ended November 30, 2006 and do not expect to become a PFIC in the future. A non-U.S. corporation is considered a PFIC for any taxable year if either (i) at least 75% of its gross income is passive income or (ii) at least 50% of the value of its assets (based on an average of the quarterly values of the assets during a taxable year) is attributable to assets that produce or are held for the production of passive income.

We will be treated as owning our proportionate share of the assets and earning our proportionate share of the income of any other corporation in which we own, directly or indirectly, more than 25% (by value) of the stock.

We must make a separate determination each year as to whether we are a PFIC. As a result, our PFIC status may change. In particular, fluctuation in the market price of our common shares may result in us becoming a PFIC.

If we are a PFIC for any taxable year, a U.S. Holder will be subject to special tax rules with respect to any excess distribution received and any gain realized from a sale or other disposition of common shares, unless such U.S. Holder makes a mark-to-market election as discussed below. Distributions received by a U.S. Holder in a taxable year that are greater than 125% of the average annual distributions received by such U.S. Holder during the shorter of the three preceding taxable years such U.S. Holder's holding period for the common shares will be treated as an excess distribution. Under these special tax rules (i) the excess

distribution or gain will be allocated ratably over the U.S. Holder's holding period for the common shares, (ii) the amount allocated to the current taxable year, and any taxable year prior to the first taxable year in which we were a PFIC, will be treated as ordinary income, and (iii) the amount allocated to each other year will be subject to tax at the highest tax rate in effect for that year and the interest charge generally applicable to underpayments of tax will be imposed on the resulting tax attributable to each such year.

The tax liability for amounts allocated to years prior to the year of disposition or excess distribution cannot be offset by any net operating losses for such years, and gains (but not losses) realized on the sale of common shares cannot be treated as capital, even if a U.S. Holder holds the common shares as capital assets.

If we are a PFIC, a U.S. Holder may avoid taxation under the rules described above by making a qualified electing fund election to include its share of our income on a current basis, or a deemed sale election once we no longer qualify as a PFIC. However, a U.S. Holder may make a qualified electing fund election only if we agree to furnish annually certain tax information, and we do not presently intend to prepare or provide such information.

Alternatively, a U.S. Holder of marketable stock in a PFIC may make a mark-to-market election for stock of a PFIC to elect out of the tax treatment discussed three paragraphs above. If a U.S. Holder makes a mark-to-market election for the common shares, it will include in income each year an amount equal to the excess, if any, of the fair market value of the common shares as of the close of its taxable year over its adjusted basis in such common shares. A U.S. Holder is allowed a deduction for the excess, if any, of the adjusted basis of the common shares over their fair market value as of the close of the taxable year. However, deductions are allowable only to the extent of any net mark-to-market gains on the common shares included in the U.S. Holder's income for prior taxable years. Amounts included in a U.S. Holder's income under a mark-to-market election, as well as gain on the actual sale or other disposition of the common shares, are treated as ordinary income. Ordinary loss treatment also applies to the deductible portion of any mark-to-market loss on the common shares, as well as to any loss realized on the actual sale or disposition of the common shares, to the extent that the amount of such loss does not exceed the net mark-to-market gains previously included for such common shares. A U.S. Holder's basis in the common shares will be adjusted to reflect any such income or loss amounts. The tax rules that apply to distributions by corporations which are not PFICs would apply to distributions by us.

The mark-to-market election is available only for stock which is regularly traded on a qualified exchange or other market, as defined in applicable Treasury regulations. Our common shares are listed on The NASDAQ Stock Market LLC and, consequently, for so long as our common shares continue to be so listed and regularly traded on such market, the mark-to-market election will be available to U.S. Holders were we to be or become a PFIC.

If a U.S. Holder holds common shares in any year in which we are a PFIC, such U.S. Holder would be required to file U.S. Internal Revenue Service Form 8621 regarding distributions received on the common shares and any gain realized on the disposition of the common shares.

#### ***Information Reporting and Backup Withholding***

In general, information reporting for U.S. federal income tax purposes will apply to distributions made on the common shares paid within the U.S. to a non-corporate U.S. person and on sales of the common shares to or through a U.S. office of a broker by a non-corporate U.S. person. Payments made outside the U.S. will be subject to information reporting in limited circumstances.

In addition, backup withholding of U.S. federal income tax will apply to distributions made on common shares within the U.S. to a non-corporate U.S. person and on sales of common shares to or through a U.S. office of a broker by a non-corporate U.S. person who (i) fails to provide an accurate

taxpayer identification number (certified on U.S. Internal Revenue Service Form W-9), (ii) is notified by the U.S. Internal Revenue Service that backup withholding will be required, or (iii) fails to comply with applicable certification requirements.

The amount of any backup withholding collected will be allowed as a credit against U.S. federal income tax liability provided that appropriate returns are filed.

#### **Bermuda Taxation**

At the present time, there is no Bermuda income or profits tax, withholding tax, capital gains tax, capital transfer tax, estate duty or inheritance tax payable by us or by our shareholders in respect of our shares. We have received an assurance from the Minister of Finance of Bermuda under the Exempted Undertakings Tax Protection Act 1966 that, in the event that any legislation is enacted in Bermuda imposing any tax computed on profits or income or computed on any capital asset, gain or appreciation or any tax in the nature of estate duty or inheritance tax, the tax shall not until March 28, 2016, be applicable to us or to any of our operations or to our shares or other obligations except in so far as the tax applies to persons ordinarily resident in Bermuda or to any taxes payable by us in respect of real property or leasehold interests in Bermuda held by us.

#### **Item 10F: Dividends and Paying Agents**

Not applicable.

#### **Item 10G: Statement by Experts**

Not applicable.

#### **Item 10H: Documents on Display**

We file annual reports and other information with the SEC pursuant to the rules and regulations of the SEC that apply to foreign private issuers. You may read and copy any of these reports at the SEC's public reference facilities at 100 F Street, N.E., Washington D.C. 20549 or obtain them by mail upon payment of prescribed rates. Please call the SEC at 1-800-SEC-0330 for further information. Copies may also be obtained from the SEC website at <http://www.sec.gov>. Information included in our website does not form part of this document.

#### **Item 10I: Subsidiary Information**

Not applicable.

#### **ITEM 11: QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

The principal market risks (*i.e.*, the risk of loss arising from adverse changes in market rates and prices) to which we are exposed are foreign exchange rates and interest rate on cash and cash equivalents and debt.

The following risk management discussion and the estimated amounts generated from analytical techniques are forward-looking statements of market risk assuming certain market conditions occur. Our actual results in the future may differ materially from these projected results due to actual developments in the global financial markets.

#### **Foreign Exchange Rates**

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 of our non-U.S. dollar operating

expenses relate to our Malaysian and U.K. operations payroll and other expenses. The value of the Malaysian Ringgit relative to the U.S. dollar is managed within a narrow range by the Malaysian government. We are therefore particularly exposed to exchange rate movements between the U.K. pound and the U.S. dollar. We partially limit our U.K. pound and Malaysian Ringgit exchange rate exposures through the use of forward foreign currency exchange contracts and currency options. By using these derivative instruments increases or decreases in our U.K. pound and Malaysian Ringgit operating expenses resulting from changes in the exchange rate are partially offset by realized gains and losses on the derivative instruments. We do not hold derivative financial instruments for trading purposes. We also have assets and liabilities denominated in U.K. pounds and therefore we are also exposed to the effect of the retranslation of these amounts as a result of movements in exchange rates. At November 30, 2006 we had \$0.9 million net U.K. pound denominated assets. A hypothetical 10% movement in exchange rates at November 30, 2006 would not have significantly impacted our net earnings.

We are exposed to credit (or repayment) risk through our use of forward foreign exchange contracts. If the counter-party to one of the forward foreign exchange contracts to which we are party fails to fulfill its performance obligations under the contract, our credit risk will equal the positive market value of the contract. When the fair market value of a forward foreign exchange contract is positive, this indicates that the counter-party owes us money, thus creating a repayment risk. When the fair market value of a forward foreign exchange contract is negative, we owe the counter-party, and therefore we assume no repayment risk. In order to minimize credit risk in forward foreign exchange contracts, we enter into transactions with high-quality counter-parties, such as financial institutions, that satisfy our established credit approval criteria. Forward foreign exchange contracts are executed only on the basis of standardized agreements.

The following table provides information about our forward foreign exchange contracts existing as of November 30, 2006 and November 30, 2005:

	November 30,	
	2006	2005
<b>Derivatives between U.K. pound and U.S. dollar</b>		
Forward exchange contracts	\$ 43,294	\$ 46,070
Fair value of contracts asset (liability)	\$ 3,762	\$ (1,658 )
Carrying value of contracts asset (liability)	\$ 3,762	\$ (1,658 )
Average rate of contract	\$ 1.80	\$ 1.84
Period end rate	\$ 1.95	\$ 1.72
Maximum period of contracts (months)	12	12
	November 30,	
	2006	2005
<b>Derivatives between Malaysian Ringgit and U.S. dollar</b>		
Forward exchange contracts and options	\$ 6,500	
Fair value of contracts asset (liability)	\$ 46	
Carrying value of contracts asset (liability)	\$ 46	
Average rate of contract	\$ 0.28	
Period end rate	\$ 0.28	
Maximum period of contracts (months)	12	

Since November 30, 2006, there has not been a material change to our market exposure related to foreign exchange rates.

#### **Interest Rates**

We had cash and cash equivalents at November 30, 2006 totaling \$56.9 million. These are primarily held in variable interest liquidity funds and overnight deposits. In addition, at November 30, 2006 we had

short and long-term bank borrowings with variable interest rates amounting to \$7.0 million. We do not hedge our exposure to interest rate fluctuations through the use of derivative instruments.

For the year ended November 30, 2006 we had average variable rate cash and cash equivalent balances, net of variable rate borrowings, of approximately \$23.4 million. A hypothetical 1% change in interest rates during our 2006 fiscal year would have impacted our net interest income by approximately \$0.2 million.

Since November 30, 2006, there has not been a material change to our market risk exposure related to interest rates.

**ITEM 12: DESCRIPTION OF SECURITIES OTHER THAN EQUITY SECURITIES**

Not applicable.

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**PART II**

**ITEM 13: DEFAULTS, DIVIDEND ARREARAGES AND DELINQUENCIES**

None.

**ITEM 14: MATERIAL MODIFICATIONS TO THE RIGHTS OF SECURITY HOLDERS AND USE OF PROCEEDS**

None.

**ITEM 15: CONTROLS AND PROCEDURES**

*Evaluation of Disclosure Controls and Procedures*

The Company maintains disclosure controls and procedures that are designed to ensure that information required to be disclosed in the Company's Securities Exchange Act of 1934 reports is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms and that such information is accumulated and communicated to the Group's management, including its Chief Executive and Chief Financial Officers, as appropriate, to allow for timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management is required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

As required by SEC Rule 13a-15(b), the Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the Company's Chief Executive and Chief Financial Officers, of the effectiveness of the design and operation of the Company's disclosure controls and procedures as of the end of the period covered by this Annual Report. Based on the foregoing, the Company's Chief Executive and Chief Financial Officers concluded that the Company's disclosure controls and procedures were effective at the reasonable assurance level.

*Management's Report on Internal Control over Financial Reporting*

Our management is responsible for establishing and maintaining adequate internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) of the Exchange Act) to provide reasonable assurance regarding the reliability of our financial reporting and the preparation financial statements for external purposes in accordance with generally accepted accounting principles. Internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of our assets; (ii) provide reasonable assurance that the transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that our receipts and expenditures are being made only in accordance with authorizations of our management and our directors; and (iii) provide reasonable assurance regarding the prevention or timely detection of unauthorized acquisition, use or disposition of our assets that could have a material effect on the financial statements.

Our management evaluated the effectiveness of our internal control over financial reporting using the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in *Internal Control - Integrated Framework*. Based on this evaluation, our management concluded that our internal control over financial reporting was effective as of the end of the period covered by this Annual Report on Form 20-F.



*Changes in Internal Control over Financial Reporting*

There have been no significant changes in the Company's internal controls or in other factors that could significantly affect our internal controls over financial reporting subsequent to the period ended 30 November 2006.

*Inherent Limitations of Effectiveness of Controls*

Our management, including our Chief Executive and Chief Financial Officers, does not expect that our disclosure controls and procedures or our internal controls over financial reporting will prevent all error and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the benefits of controls must be considered relative to their costs. Due to the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the controls. The design of any system of controls is also based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Due to the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

**Item 16A: Audit Committee Financial Expert**

Our Board of Directors has determined Ernest Sampias as an audit committee financial expert.

**Item 16B: Code of Ethics**

The Company has in place a Code of Business Conduct and Ethics that applies to all Directors, officers and employees, which qualifies as a code of ethics as required under the Sarbanes-Oxley Act of 2002. The Code of Business Conduct and Ethics applies to the Company's principal executive officer and principal financial officer, principal accounting officer or controller and other persons performing similar functions. The full text of the Code of Business Conduct and Ethics is included as an exhibit to our Annual Report on Form 20-F for our fiscal year ended November 30, 2004 (SEC File No 000-50799 as filed with the SEC on 28 February, 2005, which is available at [www.sec.gov](http://www.sec.gov).

**Item 16C: Principal Accountant Fees and Services**

The following fees were billed by our independent registered public accounting firm, PricewaterhouseCoopers LLP, during the two years ended November 30, 2006:

	<b>Year ended November 30, 2006      2005 (U.S. dollars in thousands)</b>	
Audit Fees(1)	\$ 636	\$ 485
Audit-related fees(2)	6	8
Tax fees(3)	230	450
Total fees	\$ 872	\$ 943

(1) Represents fees for professional services related to the audit of our annual consolidated financial statements for years ended November 30, 2006 and 2005, reviews of the financial statements included

in the Company's quarterly financial press releases on Form 6-k and the statutory audits of our subsidiaries.

(2) Represents fees for professional services in connection with the audit of our claims to obtain government grants.

(3) Represents fees for professional services related to tax services, including tax compliance, tax advice, tax planning and expatriate tax services.

***Audit Committee pre-approval policies and procedures***

We have established a policy addressing the independence of our external auditors and the provision of services by our external auditors. Pursuant to this policy, our external auditors may only provide certain permissible audit services, audit-related services and non-audit services that have been pre-approved by the Audit Committee. The Audit Committee has granted general pre-approval to all permissible services to be provided by the Company's external auditors not in excess of \$200,000 in aggregate in any fiscal year and that do not exceed \$50,000 per individual service provided. The Audit Committee must specifically pre-approve all services in excess of these amounts. Certain of the permissible audit services, audit-related services and non-audit services that our Audit Committee may pre-approve pursuant to the policy have been set forth below. The Audit Committee annually reviews the list of permissible pre-approved services and may add or subtract services from the list from time to time.

Permissible audit services include:

- statutory audits or financial audits for subsidiaries or affiliates, including issuing the audit opinion for Company reporting purposes and on the statutory financial statements; and
- audit of the financial statements contained in our annual report on Form 20-F, and other services associated with SEC registration statements, periodic reports and other documents filed with the SEC.

Permissible audit-related services include:

- employee benefit plan audits;
- accounting consultations on matters not reflected in the Company's financial statements (including advice on accounting policies);
- due diligence assistance relating to acquisitions and/or disposals;
- audits on divestments and acquisitions;
- internal control reviews; and
- accounting and fraud investigation.

Permissible non-audit services include:

- tax compliance, planning and related implementation advice; and
- due diligence other than in respect of acquisitions.

In the event that services to be provided by the external independent auditor do not fit within the various enumerated pre-approved services under the policy, we have implemented certain internal procedures to ensure that the provision of such services will not compromise the independence of the external auditor.

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The Audit Committee approved 100% of the non-audit fees billed by our principal accountants in the year ended November 30, 2006 under these policies and procedures.

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**Item 16D: Exemption From the Listing Standards for Audit Committees**

Not applicable.

**Item 16E: Purchase of Equity Securities by Company and Affiliated Purchasers**

None.

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**PART III**

**ITEM 17: FINANCIAL STATEMENTS**

We have responded to Item 18: Financial Statements in lieu of responding to this Item.

**ITEM 18: FINANCIAL STATEMENTS**

The following financial statements are included as part of this Annual Report:

	Page
<u>Report of Independent Registered Public Accounting Firm</u>	F-1
<u>Audited Consolidated Balance Sheets as of November 30, 2006 and 2005</u>	F-2
<u>Audited Consolidated Statements of Operations for each of the three years in the period ended November 30, 2006</u>	F-3
<u>Audited Consolidated Statements of Shareholders' Equity and Comprehensive Income for each of the three years in the period ended November 30, 2006</u>	F-4
<u>Audited Consolidated Statements of Cash Flows for each of the three years in the period ended November 30, 2006</u>	F-5
<u>Notes to the Audited Consolidated Financial Statements</u>	F-6

**Item 19: EXHIBITS**

**Exhibit**

<b>Number</b>	<b>Description</b>
1.1	Memorandum of Association of Xyratex Ltd*
1.2	Bye-Laws of Xyratex Ltd***
4.1	Lease Agreement between Havant International Limited and Xyratex Technology Limited dated June 10, 2002***
4.2	Services Agreement between Havant International Limited and Havant International Holdings Limited dated October 12, 2000*
4.3	Asset Purchase Agreement among Xyratex Technology Limited, ZT Automation LLC and ZT Automation Pte. Ltd. dated February 23, 2004*
4.4	Investment and Shareholders Agreement Relating to Xyratex Group Limited dated August 12, 2003*
4.5	Trading Agreement dated January 1, 2004*
4.6	Lease agreement between Havant International Limited and Xyratex Technology Limited dated October 10, 2005***
8	Subsidiaries of Xyratex Ltd***
11	Code of Business Conduct and Ethics**
12.1	Section 302 certification, Chief Executive Officer
12.2	Section 302 certification, Chief Financial Officer
13.1	Section 906 certification, Chief Executive Officer
13.2	Section 906 certification, Chief Financial Officer
15.1	Report of Independent Registered Public Accounting Firm on Financial Statement Schedule
15.2	Schedule II Valuation and Qualifying Accounts and Reserves

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\* Incorporated by reference to our registration statement on Form F-1 (File No. 333-116089) filed with the SEC on June 22, 2004.

\*\* Incorporated by reference to our annual report on Form 20-F (File No. 000-50799) filed with the SEC on February 28, 2005.

\*\*\* Incorporated by reference to our annual report on Form 20-F (File No. 000-50799) filed with the SEC on February 21, 2006.

**SIGNATURES**

The registrant hereby certifies that it meets all of the requirements for filing on Form 20-F and that it has duly caused and authorized the undersigned to sign this Annual Report on its behalf.

XYRATEX LTD

February 19, 2007

By: /s/ STEVE BARBER  
Chief Executive Officer

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**XYRATEX LTD**  
**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To Board of Directors and shareholders of Xyratex Ltd:

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of operations, shareholders' equity and comprehensive income (loss) and cash flows present fairly, in all material respects, the financial position of Xyratex Ltd and its subsidiaries at November 30, 2006 and 2005, and the results of their operations and their cash flows for each of the three years in the period ended November 30, 2006 in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note 2 to the financial statements, the Company changed the manner in which it accounts for share-based compensation in the year ended November 30, 2006.

PRICEWATERHOUSECOOPERS LLP

PricewaterhouseCoopers LLP  
Southampton  
England  
February 19, 2007

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**XYRATEX LTD**  
**AUDITED CONSOLIDATED BALANCE SHEETS**

	November 30, 2006	2005
	(US dollars and amounts in thousands)	
<b>ASSETS</b>		
<b>Current assets:</b>		
Cash and cash equivalents	\$ 56,921	\$ 41,240
Accounts receivable, net of allowance for doubtful accounts of \$411 and \$316	105,324	82,449
Inventories	93,111	71,543
Prepaid expenses	2,390	2,244
Deferred income taxes	2,513	6,480
Other current assets	7,247	3,236
<b>Total current assets</b>	<b>267,506</b>	<b>207,192</b>
Property, plant and equipment, net	34,471	25,643
Intangible assets, net	58,109	50,904
Deferred income taxes	15,594	17,551
<b>Total assets</b>	<b>\$ 375,680</b>	<b>\$ 301,290</b>
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>		
<b>Current liabilities:</b>		
Accounts payable	\$ 84,896	\$ 79,927
Acquisition note payable		3,000
Short-term borrowings	4,000	4,000
Employee compensation and benefits payable	16,645	13,620
Deferred revenue	16,303	16,434
Income taxes payable	1,641	421
Other accrued liabilities	14,701	15,506
<b>Total current liabilities</b>	<b>138,186</b>	<b>132,908</b>
Long-term debt	3,000	7,000
<b>Total liabilities</b>	<b>141,186</b>	<b>139,908</b>
<b>Commitments and contingencies (note 17)</b>		
<b>Shareholders equity</b>		
Common shares of Xyratex Ltd (in thousands), par value \$0.01 per share 70,000 authorized, 28,793 and 28,437 issued and outstanding	288	284
Additional paid-in capital	344,686	333,886
Accumulated other comprehensive income (loss)	2,774	(1,356 )
Accumulated deficit	(113,254 )	(171,432 )
<b>Total shareholders equity</b>	<b>234,494</b>	<b>161,382</b>
<b>Total liabilities and shareholders equity</b>	<b>\$ 375,680</b>	<b>\$ 301,290</b>

The accompanying notes are an integral part of these consolidated financial statements

**XYRATEX LTD**  
**AUDITED CONSOLIDATED STATEMENTS OF OPERATIONS**

	Year Ended November 30,					
	2006		2005		2004	
	(US dollars and amounts in thousands except per share amounts)					
Revenues		\$ 983,633		\$ 679,609		\$ 459,014
Cost of revenues non cash equity compensation	923				7,827	
Cost of revenues other	785,424	786,347	535,315	535,315	356,558	364,385
Gross profit		197,286		144,294		94,629
Operating expenses:						
Research and development development arrangement					(6,000 )	
Research and development non cash equity compensation	1,962				23,959	
Research and development other	69,429	71,391	54,327	54,327	37,429	55,388
Selling, general and administrative non cash equity compensation	4,309		828		136,363	
Selling, general and administrative other	56,140	60,449	38,014	38,842	28,005	164,368
Amortization of intangible assets		5,123		3,218		1,169
In process research and development				3,230		852
Other costs						2,388
Total operating expenses		136,963		99,617		224,165
Operating income (loss)		60,323		44,677		(129,536 )
Other income		3,167				
Interest income		1,773		1,744		1,467
Interest expense		(611 )		(568 )		(415 )
Income (loss) from continuing operations before income taxes		64,652		45,853		(128,484 )
Provision (benefit) for income taxes		6,474		3,964		(6,239 )
Net income (loss) from continuing operations		58,178		41,889		(122,245 )
Income (loss) from discontinued operations (net of taxes)				280		(12,924 )
Net income (loss)		\$ 58,178		\$ 42,169		\$ (135,169 )
Net earnings (loss) per share basic:						
Net income (loss) from continuing operations		\$ 2.03		\$ 1.48		\$ (6.72 )
Income (loss) from discontinued operations, net of income tax				0.01		(0.71 )
Net earnings (loss) per share		\$ 2.03		\$ 1.49		\$ (7.43 )
Net earnings (loss) per share diluted:						
Net income (loss) from continuing operations		\$ 1.97		\$ 1.44		\$ (6.72 )
Income (loss) from discontinued operations, net of income tax				0.01		(0.71 )
Net earnings (loss) per share		\$ 1.97		\$ 1.4		