

XYRATEX LTD  
Form 20-F  
February 20, 2008

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**XYRATEX LTD  
ANNUAL REPORT FOR THE YEAR ENDED  
NOVEMBER 30, 2007**

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**Form 20-F**

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

or

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

**For the Fiscal Year Ended November 30, 2007**

or

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

or

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

(Commission file number **000-50799**)

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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:**

**Title of each class**

**Name of each Exchange on which registered**

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Common Shares, par value \$0.01 per share

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Nasdaq Stock Market

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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:

29,237,057 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.  

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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

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. We 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.

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 this Annual Report, except as otherwise indicated or as the context otherwise requires, the "Company", "Group", "Xyratex", "we", "us" and "our" refers 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 the following independent research companies; International Data Corporation, or IDC; TrendFocus; Greentech Media Prometheus Institute; and, Yole Développement.

## 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" or the negative or other variations thereof as well as other statements regarding matters that are not historical fact, are or may constitute forward-looking statements. In addition, this Annual Report includes forward-looking statements relating to our potential exposure to various types of market risks, such as foreign exchange rate risk, interest rate risks and other risks related to financial assets and liabilities. We have based these forward-looking statements on our management's current view with respect to future events and financial performance. These views reflect the best judgment of our management but involve a number of risks and

uncertainties which could cause actual results to differ materially from those predicted in our forward-looking statements and from past results, performance or achievements. Although we believe that the estimates reflected in the forward-looking statements are reasonable, such estimates may prove to be incorrect. By their nature, forward-looking statements involve risk and uncertainty because they relate to events and depend on circumstances that will occur in the future. There are a number of factors that could cause actual results and developments to differ materially from these expressed or implied by these forward-looking statements. For further discussion of these factors and other risks, see "Part I, Item 3D Risk Factors" and "Item 5 Operating and Financial Review and Prospects."

**PART I**

**ITEM 1: IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISERS**

Not applicable.

**ITEM 2: OFFER STATISTICS AND EXPECTED TIMETABLE**

Not applicable.

**ITEM 3: KEY INFORMATION**

**Item 3A: Selected Financial Data**

The selected historical consolidated statement of operations data for the years ended November 30, 2005, 2006, and 2007 and balance sheet data for the years ended November 30, 2006 and 2007 presented below have been derived from our audited consolidated financial statements included elsewhere in this Annual Report. The selected historical consolidated statement of operations data for the years ended November 30, 2003 and 2004 and balance sheet data for the years ended November 30, 2003, 2004 and 2005 presented below have been derived from our audited consolidated financial statements not included in this report.

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, 2002 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,

	2007	2006	2005	2004	2003
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(U.S. dollars in thousands)

**Consolidated Statement of Operations Data:**

Revenues:

Networked Storage Solutions	\$ 693,990	\$ 598,752	\$ 415,379	\$ 318,692	\$ 221,714
Storage Infrastructure	237,643	384,881	264,230	140,322	112,055
<b>Total revenues</b>	<b>931,633</b>	<b>983,633</b>	<b>679,609</b>	<b>459,014</b>	<b>333,769</b>

Gross profit:

Networked Storage Solutions	100,573	82,762	64,831	56,282	39,010
Storage Infrastructure	69,716	115,447	79,463	46,174	34,739
Non-cash equity compensation(1)	(1,238)	(923)		(7,827)	(690)
<b>Total gross profit</b>	<b>169,051</b>	<b>197,286</b>	<b>144,294</b>	<b>94,629</b>	<b>73,059</b>

Operating expenses:

Research and development:

Development arrangement(2)				(6,000)	
Non-cash equity compensation(1)	2,477	1,962		23,959	2,428
Other	75,082	69,429	54,327	37,429	29,797
<b>Total research and development</b>	<b>77,559</b>	<b>71,391</b>	<b>54,327</b>	<b>55,388</b>	<b>32,225</b>

Selling, general and administrative:

Non-cash equity compensation(1)	4,342	4,309	828	136,363	54,143
Other	57,635	56,140	38,014	28,005	22,426
<b>Total selling, general and administrative</b>	<b>61,977</b>	<b>60,449</b>	<b>38,842</b>	<b>164,368</b>	<b>76,569</b>

Amortization of intangible assets	7,304	5,123	3,218	1,169	
In process research and development			3,230	852	
Other costs(1)				2,388	11,625
<b>Total operating expenses</b>	<b>146,840</b>	<b>136,963</b>	<b>99,617</b>	<b>224,165</b>	<b>120,419</b>

<b>Operating income (loss)</b>	<b>22,211</b>	<b>60,323</b>	<b>44,677</b>	<b>(129,536)</b>	<b>(47,360)</b>
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Other income	890	3,167			
Interest income (expense), net(3)	3,283	1,162	1,176	1,052	(209)

Income (loss) from continuing operations before income taxes

Income (loss) from continuing operations before income taxes	26,384	64,652	45,853	(128,484)	(47,569)
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Provision (benefit) for income taxes	(1,725)	6,474	3,964	(6,239)	(11,754)
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<b>Net income (loss) from continuing operations</b>	<b>28,109</b>	<b>58,178</b>	<b>41,889</b>	<b>(122,245)</b>	<b>(35,815)</b>
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Income (loss) from discontinued operations			280	(12,924)	(20,194)
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Gain (loss) from sale of discontinued operations					(185)
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<b>Net income (loss)</b>	<b>\$ 28,109</b>	<b>\$ 58,178</b>	<b>\$ 42,169</b>	<b>\$ (135,169)</b>	<b>\$ (56,194)</b>
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Year Ended November 30,

Net earnings (loss) from continuing operations per common share, class B ordinary and preferred ordinary share basic(4)	\$	0.97	\$	2.03	\$	1.48	\$	(6.72)	\$	(9.60)
Net earnings (loss) per common share, class B ordinary and preferred ordinary share basic(4)	\$	0.97	\$	2.03	\$	1.49	\$	(7.43)	\$	(15.07)
Net earnings (loss) from continuing operations per common share, class B ordinary and preferred ordinary share diluted(5)	\$	0.94	\$	1.97	\$	1.44	\$	(6.72)	\$	(9.60)
Net earnings (loss) per common share, class B ordinary and preferred ordinary share diluted(5)	\$	0.94	\$	1.97	\$	1.45	\$	(7.43)	\$	(15.07)

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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 significant private equity investment 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 the investor. We also recorded expenses of these transactions 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.
- (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 28,985, 28,663, 28,329, 18,195 and 3,730 Xyratex Ltd common shares and Xyratex Group Limited, class B ordinary and preferred ordinary shares outstanding for the years ended November 30, 2007, 2006, 2005, 2004 and 2003, 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 29,866, 29,604 and 29,031 Xyratex Ltd common shares outstanding for the years ended November 30, 2007, 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.

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As of November 30,

	2007	2006	2005	2004	2003
(U.S. dollars in thousands)					
<b>Consolidated Balance Sheet Data:</b>					
Cash and cash equivalents	\$ 70,678	\$ 56,921	\$ 41,240	\$ 63,495	\$ 2,008
Working capital	161,922	129,320	74,284	90,847	14,275
Total assets	410,275	375,680	301,290	205,242	111,271
Short-term borrowings and current portion of acquisition note payable		4,000	7,000	6,000	4,133
Long-term debt and acquisition note payable, net of current portion		3,000	7,000	11,000	15,000
<b>Total debt</b>		<b>7,000</b>	<b>14,000</b>	<b>17,000</b>	<b>19,133</b>
Total shareholders' equity	\$ 273,261	\$ 234,494	\$ 161,382	\$ 116,701	\$ 19,001
<b>Number of shares issued and outstanding:</b>					
Common shares	29,117	28,793	28,437	28,043	
Class B preferred ordinary shares					11,099
Class A preferred ordinary shares					8,845

**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, Seagate Technology and Western Digital. In our 2007 fiscal year, sales to these customers accounted for 56%, 12% and 12% of our revenues, respectively. In our 2006 fiscal year, these customers accounted for 46%, 28% and 8% 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 2007, Xyratex provided nearly all the storage system enclosure requirements of the Network Appliance product lines. Any large penetration by a competitor 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. This represented a significant consolidation in the disk drive marketplace and created a reduction in demand for our products in 2007 which is expected to continue into 2008. Further industry consolidation involving our customers could also result in a reduction in demand for our products. In particular, 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 primarily 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	Net Income
	(unaudited)	
	(U.S. dollars in thousands)	
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
First Quarter 2007	236,407	10,115
Second Quarter 2007	213,025	2,001
Third Quarter 2007	234,214	4,266
Fourth Quarter 2007	\$ 247,988	\$ 11,727

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 sale of disk drives as components of our storage systems and the market is highly competitive and subject to intense pricing pressures. Our sales related to 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:

Changes in product mix and the component content of products.

Shipment volumes a proportion of our cost of sales is fixed and therefore increases or decreases in volumes result in increases or decreases in gross margins.

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.

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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 Corporation. 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. For example, 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;

companies providing capital equipment to disk drive manufacturers, including existing suppliers of products, such as SpeedFam Co. Ltd., Teradyne, Inc., and Veeco Instruments, Inc.;

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 unable to identify 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 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.

***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 Flextronics International Ltd. as our sole source supplier for the provision of electronic circuit boards. Our reliance on Flextronics 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 Flextronics, or if Flextronics 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 previously 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 are investing in a new Enterprise Resource Planning infrastructure throughout the company in order to sustain our strategic growth objectives. In 2007 we implemented SAP in certain of our manufacturing locations 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 drive media 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 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 and therefore 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. In January 2008 we commenced a program to repurchase our common shares to a value of up to \$30 million over approximately six months. We currently intend to retain any remaining available earnings which have been or may be generated by our operations to develop and grow our business and we do not currently anticipate paying any dividends on our common shares.

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

We operate in the storage and networking technology markets. Our key management and technical staff are located in the United Kingdom, the United States, and in Malaysia. Particularly in the United Kingdom and California there is strong competition for the highly qualified management and technical personnel with experience in our markets that we need to run our business and to develop new technologies and products. In California, in particular, the rate of turnover of key personnel in our markets is high. Our future success depends in part on our continued ability to hire and retain well-qualified technical personnel. We also rely heavily on our senior management and their ability to maintain relationships with our key customers. Many of our senior managers would be difficult to replace. In addition, we do not maintain key-person life insurance on any member of our senior management, with the exception of our Chief Executive Officer. The loss of any of our key management or technical personnel could significantly harm our financial condition.

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

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

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

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

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

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

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

Our operations inside and outside the United States are subject to laws and regulations relating to the protection of the environment, including those governing the discharge of pollutants into the air and water, the management and disposal of hazardous substances and wastes and the clean-up of contaminated sites. Certain of our operations involve the use of substances regulated under various federal, state and international environmental laws. It is our policy to apply strict standards for environmental protection to sites inside and outside the United States, even if not subject to regulations imposed by local governments. We could also incur substantial costs, including clean-up costs, fines and civil or criminal sanctions, third-party property damage or personal injury claims if we were to violate or become liable under environmental laws or become non-compliant with environmental permits required at our facilities.

The European Parliament has enacted the Restriction on Use of Hazardous Substances Directive, or RoHS Directive, which restricts the sale of new electrical and electronic equipment containing certain hazardous substances, including lead, which is currently used in some of the products we manufacture. Similar legislation has been introduced by China, with further similar such legislation anticipated in the future by other countries. We have modified 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. Moreover, we have complied with the currently defined China RoHS requirements. By working closely with our suppliers to redesign or reformulate their components containing the hazardous substances we have reduced or eliminated these materials from our products. However, if we do not continue to comply with these directives 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. To meet certain legal requirements under the WEEE Directive, Xyratex has become a member of a business to business recycling scheme. 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, 2007, our internal controls over financial reporting were effective, we cannot predict the outcome of our testing in future periods. 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 2008 fiscal year we are planning to complete the replacement of 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 and 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 or of listed companies generally 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 49% 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**

See INTRODUCTION

##### **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: Networked Storage Solutions (NSS) and Storage Infrastructure (SI).

Our NSS products provide modular, highly scalable, high-speed, high-density, reliable and flexible data storage. Our hard disk drive based storage subsystems support a range of high-speed communication technologies to demanding 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 2006 and 2007, we estimate that we are responsible for between 13 and 15% of the world wide external storage systems terabyte shipments through our original equipment manufacturers (OEM) customer base. This amounted to 662 petabytes in 2007, an increase from 399 petabytes in 2006. A terabyte and a petabyte are units of measurement equal to one thousand gigabytes and one million gigabytes of information, respectively.

Our SI products include disk drive production test systems, process automation for disk drive and solar panel manufacturing, servo track writers and disk cleaning systems. We believe that approximately 75% of all 3.5-inch disk drives shipped and approximately 35% of all 2.5-inch disk drives shipped worldwide are processed utilizing either our servo track writer or final test and qualification systems.

We also estimate that our SI revenues on average account for approximately 15% of the capital spend within the annual capital budget of the disk drive industry.

We have over 20 years of experience in research and development relating to disk drives, storage systems, high-speed communication protocols and manufacturing process technology. This experience has enabled us to establish long-term, strategic relationships with customers and related technology suppliers. We believe that 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. In 2006, following the successful integration of nStor technology we began shipments in volume of captive Redundant Array of Independent Devices (RAID) technology and were first to volume shipment of mixed Serial Attached SCSI (SAS)/Serial Advanced Technology Architecture (SATA) storage systems. In 2005 we announced a number of significant patent filings in the areas of optical backplane interconnect. Our storage subsystem and process equipment products enable our customers to improve asset utilization, reduce capital costs and better focus on their value-added objectives.

Our patent portfolio continues to reflect our innovation with around 403 filings worldwide and we manage a number of research consortia, with industrial and academic partners, focusing on long term needs of storage system users and markets.

We have research and development, manufacturing and sales operations in the United States, Asia and Europe. Our research and development activities are located in the United Kingdom, United States, Malaysia, Singapore and India enabling us to optimize skill mix and costs. We have manufacturing locations in the United Kingdom, United States and Malaysia and support our customers through a number of other locations in Asia. We continually look for efficiencies and improvements in supply lines that can benefit our customers. For example we have recently established NSS product manufacturing in Malaysia as our customers' demand in the Asia region increases. We also review our technology suppliers and sources to optimize operational and development costs.

We sell our NSS products primarily to OEMs, and our SI products primarily to disk drive manufacturers or their component suppliers. 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.

We believe that we derive advantages from the technology and skill synergies and requirements across our NSS and SI 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**

Worldwide storage demand continues to increase significantly, driven by 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. According to IDC Worldwide Disk Storage Systems Forecast Dec 2007, shipments of storage in terms of terabytes are expected to increase at a compound annual growth rate (CAGR) of 57% until 2011, reaching 33.0 million terabytes in 2011.

The increased demand for electronic data storage is primarily being satisfied by hardware solutions incorporating hard disk drives ("HDDs"), requiring an increase in both unit volumes and average

storage capacities of HDDs. Much continues to be written about the competition hard disk drives face from flash memory. However, we believe that HDDs will continue to provide the best value for mass storage and will remain the dominant technology for large capacity storage applications for many years to come, potentially combined with flash memory in the overall solution. Unit volume shipments of HDDs reached 500 million in 2007 and are expected to continue to grow annually to around 750 million in 2011 (TrendFocus Q4 2007 Storage Quarterly Update, published in February 2008, and TrendFocus Storage Revised Long-Term Forecast Update, published in August 2007).

In addition to the growth in volume of data, the market for data storage products and services is also affected by the variety in the source and purposes of data both in the enterprise and consumer market. Businesses 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 disk drive storage and networking technologies developed to address different data management requirements. Businesses are also now increasingly focusing on the issues surrounding increasing power consumption and thermal management to maintain compliance with emerging environmental legislation and reduce energy costs.

This increased storage requirement and proliferation of storage technologies lead us to believe that there is a growing opportunity for outsourced product and service offerings within the data storage and IT marketplace. According to IDC, in a report issued in May of 2007, 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 \$87 billion in 2009.

## **Networked Storage Solutions Market and Products**

### **Market**

There are a number of dynamics that affect the market for the NSS division's storage subsystem products and services, some of which are as follows:

OEM outsourcing of storage products typically taking place at the time of technology transitions.

Continued growth of networked storage (both Networked Attached Storage or NAS and Storage Area Networks or SAN) rather than direct attached storage.

High Capacity/Low Cost Disk Storage.

Compliance and regulatory storage needs.

Power efficiency to support global environmental initiatives and pressures.

High performance storage solutions addressing markets such as video and rich media markets.

*OEM outsourcing of storage products typically taking place at the time of technology transitions:* Technology transitions provide opportunities to introduce new products such as the transition of Fibre Channel (FC) based storage systems to SAS which is well established in internal disk drive interfaces of servers. Another transition is from internal server disk storage to lower price band RAID subsystems. Our strategy is to provide these new capabilities to our OEM customers on a timely basis such that they can either add their own value through other advanced functionality or to package solutions to the various market segments. We expect this transition to continue into the higher price band products, providing additional opportunity for Enterprise class subsystems and solutions.

*Continued growth of networked storage (both NAS and SAN) rather than direct attached storage:* Over the last few years we have seen the gradual transition from direct attached storage (typically using Parallel SCSI as its interface) to networked storage, typically employing either FC or Gigabit Ethernet, we address these markets either directly or through our OEM customers who provide both SAN and

NAS storage solutions with a wide range of products. Other trends such as various forms of storage virtualization which again utilize the same base building components of disk storage subsystems with or without RAID capability are also addressed. The trend toward this type of enterprise consolidation through virtualization is expected to continue and allows lower level storage systems to be utilized more readily.

*High Capacity/Low Cost Disk Storage:* Data retention, management of fixed content and disk-to-disk backup (and disk-to-disk-to-tape) are leading the way for the growth in capacity-oriented disk drives. From a terabyte perspective these high capacity-low cost systems are projected to grow at almost three times as fast as the performance oriented (SAS/FC). This was evidenced by IDC's mid 2007 update report which stated that the revenue for storage systems containing capacity optimized disk drive technology will grow from \$3.2 billion in 2006 to \$11.6 billion in 2010, representing a CAGR of 35%. The same report also stated that the petabyte shipment growth for this same segment is at 90% compound growth over this period. This huge growth is driven by emerging storage intensive markets such as rich media archives, healthcare and vaulting and is addressed through ultra-high disk density storage solutions such as our 48 drive enclosure with RAID 6 protection and power efficient operation.

*Compliance and Regulatory storage needs:* Regulatory compliance, such as the Sarbanes-Oxley Act of 2002, is a growing concern for most industries on a global basis, and is driving a significant volume of data which must be stored over an extended period of time.

*Power efficient global initiatives and environmental pressures:* Another key driver that has grown spectacularly in importance over the past two years is the provision of power efficient or 'Green' solutions. Xyratex has and continues to invest in improvements in both the basic hardware capabilities and the efficient use of data storage resources to minimize power consumption (reduced cost of ownership) and also designs product to minimize ecological impact throughout a product's lifecycle. We believe that data protection, distributed environments, and disk-based backup will drive networked storage growth and that "green credentials" will be an increasingly important decision point for many customers in the future.

*High performance storage solutions addressing markets such as video and rich media markets:* We believe the creation and distribution of entertainment content is the largest driver in the growth of digital storage. Acquisition, editing, archiving and distribution of digital content together with increasing distribution over the internet and digital cinema technology deployment all require large amounts of storage. Higher definition digital camera technology continues to replace film in movie production and high definition television channels increase both the performance and capacity demanded of storage systems.

Storage products can typically be differentiated by capacity, performance, price and feature set to address three market segments;

Entry-level storage products are designed for relatively low capacity, simple, stand-alone data storage needs for which price and simplicity are the main purchasing considerations often these are the requirements of small and medium sized businesses (SMBs),

Midrange or departmental/workgroup storage products are designed for higher capacity and performance than entry-level products, but still feature ease of use and manageability, and are attached to a local server or a network of servers tailored to the needs of the local users,

High-end or enterprise storage products are designed for use by larger organizations where data storage and management is critical. These organizations require large capacity storage systems that feature high performance, automation, extreme reliability, continuous availability, operating systems interoperability and global service and support.

Our products are generally aimed at the mid-range and entry level markets.

## Products and Services

We design, develop and manufacture modular, highly scalable, high-speed, high-density, reliable and flexible data storage. Our storage subsystems comprise modules such as our storage controllers and disk drive enclosures and support a range of high-speed communication technologies and cost and performance specifications.

Our technology and design capabilities are matched by our manufacturing and configuration services to deliver a customer package unique to the industry. Our focus areas include:

Strategic Alliances and Partnerships, providing industry technology leadership through organizations such as the Storage Bridge Bay working group (SBB), the Storage Network Industry Association (SNIA), the Green Grid and the International Disk Drive Equipment and Materials Association (IDEMA). We operate close partnerships with key suppliers both of technology and manufacturing services. To aid expansion of our available markets we embrace international industry standards, including the American National Standards Institute (ANSI), and industry collaborative standards, driving specifications such as SBB working alongside other leaders of the storage industry including EMC, Dell, IBM, Network Appliance and LSI.

Our customer partnerships often include the manufacturing and supply of customer developed product elements as well as customization of more generic platforms, providing a much more cohesive bond between ourselves and the customer than that experienced with standard product sales.

Excellent hardware design providing highly modular power and packaging enabling us to deliver a range of products either as generic design or OEM specific derivatives. Our products provide the high speed digital interfaces to multiple disk drives using FC, SAS and SATA technologies. These interfaces are provided with redundancy and enhanced diagnostic capabilities ensuring system availability even during maintenance. Disk drives must be provided with an essentially benign physical environment with effective cooling and mechanical structure to ensure reliability is not compromised, improvements in the design and materials ensure maximum efficiency and device management techniques as well as end of life recyclability provide the most ecologically friendly and power efficient product. These products we provide to OEMs are typically referred to as JBOD (Just a Bunch of Disks) subsystems. We also provide SBOD (Switched Bunch of Disks) and EBOD (Expandable Bunch of Disks) subsystems. The SBOD subsystems combine the performance and scalability of Fibre Channel connectivity with the increased resiliency of a switch architecture. The EBOD subsystems combine the performance and scalability of SAS Connectivity with the increased flexibility to support high performance enterprise SAS drives and high capacity low cost SATA drives in the same system.

We provide RAID technology to further protect users from failure of disk drives, ensuring they have 24x7 access to data. Our RAID technology provides cost effective solutions with high performance and a range of features including RAID 6 (the ability to deliver data even with two concurrent disk drive faults), and Snapshots (instantaneous point in time copies of data). Current products include a 12 drive system (5412) and the 5404 which provides the industry's highest drive density RAID solution incorporating 48 terabytes of storage capacity in a 4 unit high package with high availability (redundant) controllers. These products are more complete SAN 'solutions' particularly suited to sale through channels other than to OEMs.

Our OneStor range of products announced in November 2007 complies with the latest industry standard SBB Version 2 specification and incorporates dynamic cooling, high efficiency power and modularity allowing ourselves and our OEM customers to create a wide range of storage solutions with maximum re-use of design and components. This product range, our fourth generation of OEM subsystem is the most modular and flexible product to date. It provides failsafe/redundant power, interconnects, cooling and serviceability. Current products include 12, 14, 16 and 24 disk drive packages.

Our 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 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 customers' controlling software and management technology through industry standard interfaces. Increasingly we can provide this software both integrated within the product or independently to tightly integrate with OEM customers' own hardware and software.

A cornerstone of our manufacturing process is our certification test (CERT) process, which has been internally developed and is continually evolved as we integrate the latest available HDDs. The process is undertaken on all our storage system products and provides a simulation of how the storage system and its HDDs will perform over an extended period of time. This process and actions taken following the analysis of the test results, has been shown to dramatically improve early life failure rates and potential field returns.

As an OEM supplier we extend our overall offering beyond the specific product and view the provision of an industry leading manufacturing, supply and delivery process as an essential element of our overall competitive strength.

Our manufacturing operations based in the United States, United Kingdom and Malaysia are tightly integrated with key suppliers primarily in lower cost regions, delivering both volume and product mix flexibility and efficiency. The modular manufacturing lines can be easily moved to the most efficient worldwide location and provide a quality and reliability of finished goods which we believe to be unsurpassed in the industry.

Flexibility in supply has enabled us to support our customers' growth. For some customers we provide both standard products and highly customized products integrating hardware components developed by our customers. We can provide products as component elements or as complete packaged solutions directly shipping to freight consolidators.

## **Storage Infrastructure Market and Products**

### **Market**

We provide capital process equipment, primarily to HDD manufacturers, and the market for our products is driven by the overall demand for electronic storage using HDDs, facilitated by increases in both HDD unit shipments and the average capacity of HDDs. In addition we have recently initiated shipments of process automation equipment within the Solar Photovoltaic ("PV") industry.

Disk drive unit sales in 2007 grew at a rate of 15.3%, to 502 million, and were forecasted to be 747 million in 2011, corresponding to a 10.4% CAGR (TrendFocus Q4 2007 Storage Quarterly Update published in February 2008, and TrendFocus Storage Revised Long-Term Forecast Update, published in August 2007). These increases are being seen across the various markets for HDDs:

*HDDs for Mobile Computing:* The mobile computing market, primarily using the 2.5" disk, is expected to grow faster than that for desktop computers as price and performance continue to improve. According to the above mentioned TrendFocus Q4 2007 Storage Quarterly Update in 2007 disk drives for mobile compute applications grew 42%.

*HDDs for Consumer Electronics:* HDDs for the consumer market are being focused on areas that require significant storage capabilities such as Digital Video Recorders (DVRs) and gaming consoles, where storage requirements will increase further with the wider adoption of high definition content. Disk drives for consumer electronics applications were forecasted to grow an average 23% per year between 2007 and 2011 (TrendFocus Q4 2007 Storage Quarterly Update, published in February 2008, and TrendFocus Storage Revised Long-Term Forecast Update, published in August 2007).

*HDDs for Desktop Computing:* We believe that the growth in HDDs for desktop computing has slowed, due in part to the shift to notebook computers. According to the same TrendFocus reports, disk drives for desktop applications were currently forecasted to grow an average 1% per year between 2007 and 2011.

*HDDs for Enterprise Storage:* The need to address the expansion in the data storage management requirements, as experienced in our NSS business, has increased the demand for new hardware storage solutions for both mission critical and business critical enterprise storage. In addition to the growth in mission critical enterprise storage there has been a significant growth in the use of high capacity, enterprise class SATA products in business critical storage systems used by enterprises to store and access capacity-intensive non-critical data. According to the same TrendFocus reports, disk drives for enterprise applications were forecasted to grow an average 1% per year between 2007 and 2011. This value does not include the additional unit growth due to high-capacity SATA drives predominantly used in near-line storage applications for enterprise customers.

The emergence in 2005 of Perpendicular Magnetic Recording (PMR) techniques within HDDs has enabled the trend in increasing areal density, which is the measure of storage capacity per square inch on the recording surface of a disk, to continue. PMR 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 unit area, whilst simultaneously reducing the footprint of each individual bit on the disk's surface dramatically increasing the number of bits per square inch. According to the TrendFocus HDD Recording Head quarterly reports, the transition to perpendicular recording is happening faster than expected, and in Q4 2007 PMR already represented 85% of total hard disk drive heads used, replacing Giant Magneto-Resistive (GMR) as the more used disk drive head technology. The PMR technology allows for a higher areal density and the TrendFocus 2007 Rigid Media & Substrate Annual Study (published in March 2007) forecasted that 3.5-inch disks are expected to see the maximum gigabytes per disk grow from 187 in 2006 to 750 in 2011. 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 disk and that this should result in increased investment cycles in precision cleaning equipment and automated optical inspection techniques.

The unit demand for large capacity drives (defined here as those containing 500 or more gigabytes) is expected to increase from 13.9 million in 2007 to 350 million in 2011 (TrendFocus Q4 2007 Storage Quarterly Update, published in February 2008, and TrendFocus Storage Revised Long-Term Forecast Update, published in August 2007). From a 7% unit share in 2007, this volume is expected to reach a 47% share in 2011. We believe that 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 disks per drive to achieve the higher storage capacity.

According to the TrendFocus 2007 Rigid Media & Substrate Update (Published in February 2008), in 2007 finished media shipments grew 12%, to 879 million, while substrate sales jumped 27%, to 1,073 million. The expected 2007-2011 CAGRs are 6.4% for media and 4.8% for substrates (TrendFocus Rigid Media & Substrate Revised Long-Term Forecast Update, published in August 2007, and TrendFocus 2007 Rigid Media & Substrate Update published in February 2008).

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Regarding the solar PV market, reports and articles published in August 2007 by the independent market research firm Greentech Media Prometheus Institute, show that the solar PV module market was expected to grow from \$7.9 billion in 2006 to over \$21.5 billion in 2010 (29% CAGR).

According to the report Photovoltaic Techno Equipment Applications and Markets, published in August 2007 by the independent research firm Yole Développement, the market for solar PV cell equipment was forecasted to be €1.1 billion (\$1.5 billion) in 2007, growing to €4.2 billion (\$5.8 billion) by 2011 (41% CAGR). This estimate was limited to cells (i.e. excluded was any equipment used for making polysilicon, silicon ingots, and wafers, or for assembling modules) and also didn't include the following cell equipment: plasma etching equipment, dry cleaning equipment, mechanical (sawing, cutting, grinding) tools, and any equipment used in the newest technologies (CdTe, CIGS, dye-sensitized, etc.).

### Products and services

We are the leading global independent provider of disk drive production test, media automation, servo-track writing equipment and disk cleaning systems. We also provide automation and test solutions for the solar PV market, and we are in the process of reviewing potential options to expand our range of products for this market.

Our SI 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 Western Digital, Seagate Technology, and Hitachi. Our SI products are capable of covering all disk drive form factors, including 3.5, 2.5, 1.8, 1.0, and 0.85 inch disk drives.

Our SI products include the following:

*Disk Drive Production Test Systems.* We design and manufacture fully automated process test systems which incorporate mechanical and electronic hardware and firmware 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, and are capable of testing a full range of disk drive protocols and form factors currently available on the market (protocols include high-speed FC, 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.

*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, cassette-less handling, cascade scrubber, and Hot IPA Vapor Assist Dryer modules.



*Media and Solar PV Automation Solutions.* Our automation solutions cover all major aspects of magnetic disk media and solar PV processing requirements, including disk/wafer/cell/module handling and tracking, cassette transport with intelligent routing, disk/wafer/cell stacking and process management software. Disk and solar PV 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. In 2007 we were successful in evolving our media automation solutions into solutions which could be used in the production process of solar PV products. We are currently working closely with and shipping to one customer in this industry with a view to becoming an established provider within this industry.

We are investigating additional products and services to address further opportunities in the hard disk drive and solar PV markets. Furthermore, we are actively seeking other markets where our technology, experience, and skills can be applied to provide distinctive advantages to these new customers.

Our product options provide solutions supporting a range of disk, disk drive, wafer, cell, and module 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 and solar PV manufacturers cost efficiencies, time-to-market advantages and enable them to prioritize their internal resources in order to achieve their strategic objectives.

### **Growth strategy**

Xyratex's strategy for growth and improved profitability focuses on the following key activities:

*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, EBOD and RAID storage subsystems, disk drive servo track writers and disk drive production testers, high throughput automation systems, and precision cleaning. 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. From time to time we may also acquire companies which possess technologies that we believe are important to our strategic development.

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*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, solar PV, 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.

*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, and have applied our high precision disk handling and automation technology into the solar PV market.

*Focusing on Operational Efficiency:* We will look to continue improving our operational efficiency through better supply chain management, including additional outsourcing, and the development of modular components within both our NSS and SI products.

### **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 three customers are Network Appliance, Seagate Technology and Western Digital. In our 2007 fiscal year sales to these customers accounted for 56%, 12% and 12% of our revenues, respectively, in total 80% of our revenues. During our fiscal year ended 2006, our top three customers accounted for 82% of our revenues. The loss of any of our top three 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 2007 we established over 11 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. The Sacramento and Seremban locations achieved certification in 1999 and 2000 respectively and since then all three locations have progressed to and maintain certification to the latest ISO 9001:2000 standard.

## Environmental Commitments and Worldwide 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 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 2007 Xyratex successfully met the requirements for ISO 14001 at its Seremban and Sacramento manufacturing locations. Since 2005 we have successfully met the compliance requirements for ISO 14001 at our UK research and production facility in Havant.

## 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 that 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 activities are essential to ensure our products remain competitive in both economic and technology terms as the data storage industry continues to evolve at a rapid pace.

Our core technical expertise covers a number of disciplines:

mechanical engineering; critical to ensure optimal performance of disk drives both during manufacturing processes and in data storage subsystems;

high speed electronics and interfaces; including current and developing network and storage related data transfer protocols such as iSCSI, FCAL, Ethernet and SAS, electronic and electro-mechanical control systems; and,

both firmware (embedded software) and system control and data storage management software.



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Since our integration of our nStor acquisition in 2005 we have and will continue to develop our RAID technology providing it with improved performance, features and functions.

Our products provide technology platforms for other equipment manufacturers to run their applications where storage and processing capabilities must be current and effective.

We typically undertake between 8 to 10 significant research and development efforts each year, in addition to a number of smaller research and development projects. In the year ended November 30, 2007, we have engaged in 21 research and development projects related to our NSS business and 24 projects related to our SI business. Approximately 7 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 \$203.3 million 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 10 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 research and development projects with our customers and also with industry and academia through consortia (including projects partially funded by the European Union and U.K. government). 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, Heathrow, San Jose and Scotts Valley, United States; Singapore; Seremban, Malaysia and through an outsourced provider in Hyderabad, India.

### **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, 2007, we had 112 U.S. patents granted, 73 U.S. patents pending, 72 non-U.S. patents granted and 146 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 NSS 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 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. Over the next year we are planning to complete the transition to SAP, a replacement Enterprise Resource Planning system, across the whole company.

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.

### **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 generally 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.

We have an agreement with Flextronics International Ltd., 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 Flextronics and others in order to effectively manage our electronic card inventory, to control component costs, and to incorporate design upgrades. Our agreement with Flextronics 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 Flextronics. We order electronic cards from Flextronics through purchase orders, as and when required. Our trading agreement with Flextronics:

permits assignment of the trading agreement by us or Flextronics with written consent;

provides that the trading agreement may be terminated in the event that Flextronics becomes bankrupt or enters into receivership;

prohibits the disclosure of Xyratex confidential information to third parties and requires that Flextronics obtain our prior approval before publicizing or advertising certain products;

contains product quality warranties that require electronic cards supplied by Flextronics 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 Flextronics and held at Flextronics' 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.

## **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 that 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, 2007 we had 220 employees involved in sales, marketing and customer service 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.

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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,		
	2007	2006	2005
United States	59.0%	50.9%	52.0%
Asia	24.2%	38.2%	37.2%
Europe	16.8%	10.9%	10.8%

### Competition

The market for NSS and SI 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 that 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.

Our NSS division competes with companies active in providing storage subsystems and components to OEMs, including Dot Hill Systems Corp., LSI Corporation and Sanmina-SCI (trading as Newisys). 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. Our SI division competes with companies offering equipment and automation to the disk drive and solar PV markets, including SpeedFam Co. Ltd., Teradyne, Inc., and Veeco Instruments, Inc. and numerous automation integrators. We also face competition from internal development efforts of existing and potential customers, in collaboration with EMS partners.

### 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 at leased premises in Havant, United Kingdom. Our U.S. research and development operations occupy leased facilities in Heathrow, Florida, Ithaca, New York and Chicago, Illinois. We maintain production operations in Sacramento, San Jose and Scotts Valley, California. In Asia, we own production and research and development operations in Seremban, Malaysia. We also lease office space in Penang, Malaysia, Singapore, China, Thailand, and Tokyo, Japan, all for sales and customer support. The following table lists significant space occupied by us as at November 30, 2007:

Country	Location	Office space	Manufacturing space	Total space
		(square feet)	(square feet)	(square feet)
U.K.	Havant	89,000	33,000	122,000
U.S.	Sacramento, California	16,000	97,000	113,000
	San Jose, California	36,000		36,000
	Scotts Valley, California	10,000	20,000	30,000
	Other US	38,000		38,000
Asia	Seremban, Malaysia	34,000	94,000	128,000
	Penang, Malaysia	9,000		9,000
	Other Asia	12,000		12,000
<b>Total</b>		<b>244,000</b>	<b>244,000</b>	<b>488,000</b>

#### ITEM 4A: UNRESOLVED STAFF COMMENTS

None.

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

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

**Overview**

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

Our Networked Storage Solutions products are primarily storage subsystems, which we provide to OEMs and our Storage Infrastructure products consist of disk drive manufacturing process equipment, which we sell directly to manufacturers of disk drives and disk drive components. We form long-term strategic relationships with our customers and we support them through our operations in the United States, Asia and Europe. In our 2007 fiscal year, sales to our top three customers, Network Appliance, Seagate Technology and Western Digital, accounted for 56%, 12% and 12% of our revenues, respectively. In our 2006 fiscal year, sales to these customers accounted for 46%, 28% and 8% of our revenues, respectively. We had 47 customers which individually contributed more than \$0.5 million to revenues in our 2007 fiscal year and 49 in our 2006 fiscal year. At November 30, 2007 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.

**Highlights of 2007**

Revenues from sales of our Networked Storage Solutions products continued to grow with an increase of approximately 16% in our 2007 fiscal year. This was driven by growth in demand across our customer base, including from our top customer in this segment, Network Appliance. We see the opportunity for continued growth over the next several years based on growth in the underlying market and specific opportunities with existing and potential future OEM customers.

Revenues from sales of Storage Infrastructure products decreased by approximately 38%, primarily as a result of a decrease in demand from Seagate Technology. The decline followed their purchase of an exceptional level of additional production capacity in 2006 in connection with their acquisition of Maxtor as described in the revenue section below. Whilst the opportunity for growth in the longer term remains, we anticipate that revenues from our Storage Infrastructure products will continue to be impacted by this factor during our 2008 fiscal year.

Gross margins decreased from 20.1% to 18.1% due primarily to the reduction in higher margin Storage Infrastructure revenues. Networked Storage Solutions gross margins increased from 13.8% to 14.5% as a result of an improved product mix and improved margins on products launched in 2006.

Our expenditure on research and development increased by 9% as we continued to develop new products for both of our operating segments. For example, in our Storage Infrastructure segment we introduced a number of process automation products for disk media and solar panel manufacturing. In our Networked Storage Solutions segment we developed a new generation of storage arrays for Network Appliance, we launched our new OneStor product line and we

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demonstrated our new RAID product, the F5404E, which is aimed at applications requiring large-capacity and low-cost disk storage. We expect to continue to increase this expenditure as we see further opportunities for revenue growth.

We held selling, general and administrative expenses essentially flat, having anticipated the reduction in Storage Infrastructure revenues.

Net income fell by 52% to \$28.1 million primarily as a result of the lower Storage Infrastructure revenues. 2007 net income included an income tax benefit of \$1.7 million due to adjustments to prior periods and a change in exchange rates and \$2.1 million increased interest income due to higher cash balances.

### *Acquisitions*

In September 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.

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.

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 addition, 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 in July 2006, a general patent cross license arrangement with IBM in December 2006 and the acquisition of certain assets and intellectual property from Ario Data Networks Inc, also in December 2006. 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. We also concluded two intellectual property licenses relating to the Xyratex portfolio of patents and filings. In March 2006 we licensed our network analysis patent portfolio and transferred the related product line to Napatech, a programmable network adapter company based in Denmark and in August 2006 we licensed our cross bar switching patent portfolio to Virtensys, a U.K. technology start up. In total these transactions resulted in us recording purchases of intangible and other assets totaling approximately \$9.0 million, of which \$5.0 million was recorded during our 2007 fiscal year. We recorded other income of \$4.1 million related to our license to Napatech, of which a \$0.9 million final payment was recorded during our 2007 fiscal year and the remainder was recorded in our 2006 fiscal year.

## *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 that 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 primarily driven by magnetic tape technology being replaced by storage systems containing low cost disk drive technology in the backup 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 primarily derived from the sale of disk drive manufacturing process equipment directly to manufacturers of disk drives and disk drive components. 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 for Networked Storage Solutions products 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.

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 many of 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 that 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 represented a significant consolidation among disk drive suppliers and caused significant changes in market share. We believe these market share changes 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 that Seagate is reutilizing certain Maxtor-owned equipment, which was previously planned to be replaced by Xyratex equipment. This surplus capacity and planned reutilization of Maxtor owned equipment has resulted in a significant decline in our revenues during 2007 fiscal year compared to our 2006 fiscal year and whilst the opportunity for growth in the longer term remains, we anticipate that revenues from our Storage Infrastructure products will continue be impacted by these factors during our 2008 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 \$71 million in our 2007 fiscal year) of our non-U.S. dollar operating expenses relates 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 9% 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. Our 2007 operating expenses increased by approximately \$3.0 million from our 2006 fiscal year as a result of this movement and excluding the effect of future movements in the exchange rate, we anticipate this movement will increase our operating expenses by an additional \$5.0 million in our 2008 fiscal year.

#### ***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 2007 fiscal year our research and development expenses related to over approximately 45 separate projects and consisted of approximately \$45.1 million related to improving existing products, \$16.7 million to meet customer specific requirements and \$13.3 million related to entering new markets, such as development of the Storage Bridge Bay (SBB) compliant OneStor platform and the application of our media process automation technology to solar cell manufacturing.

As of November, 2007 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. Over the longer term we expect this trend to continue. In our 2007 fiscal year, although revenues have declined, we have continued to increase our research and development expenditure. This reflects our continuing commitment to developing products based on advanced technologies and designs to support growth in Networked Storage Solutions revenues and the longer term opportunities for growth of our Storage Infrastructure revenues.

#### ***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.

#### ***Equity Compensation Expense***

With effect from our 2006 fiscal year we have recorded equity compensation expense using the fair value method required by Financial Accounting Standard (FAS) 123R "Share Based Payment". Equity compensation expense calculated under FAS 123R for our 2007 and 2006 fiscal years was \$8.1 million and \$7.2 million respectively. In our 2005 fiscal year we applied the intrinsic value method set out in APB 25 and our equity compensation expense for that year was \$0.9 million.

#### ***Provision for Income Taxes***

We are subject to taxation primarily in the United Kingdom, the United States and Malaysia. Our Malaysian operations benefit from a beneficial tax 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 substantially all of our operations in Malaysia until 2012, provided that we meet certain requirements. In the United Kingdom and the United States we benefit from research and development tax credits. As of November 30, 2007 we recorded a deferred tax asset of \$15.4 million related to loss-carry forwards and other timing differences in the United Kingdom. The majority of this asset is denominated in U.K. pounds and income tax expense will therefore include exchange adjustments to this asset. 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 \$7.3 million, \$5.3 million relates to equity compensation expense as described in the next paragraph and \$2.9 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 \$3.5 million which is included in the deferred tax asset at November 30, 2007. We also recorded a

deferred tax asset of \$1.8 million related to equity compensation expense calculated under the intrinsic method prior to our 2006 fiscal year. The realization of these elements of our deferred tax asset is dependent on future share price movements over the next four fiscal years. We anticipate recording any variation to the value of this asset as an adjustment to Additional Paid in Capital.

Tax payments in our 2007 fiscal year amounted to \$0.5 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 2008 fiscal year. Over the last three fiscal years our tax benefit or expense has primarily consisted of U.S. current taxes and movements in the U.K. deferred tax asset.

### 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,		
	2007	2006	2005
Revenues	100.0%	100.0%	100.0%
Cost of revenues non-cash equity compensation	0.1	0.1	
Cost of revenues other	81.7	79.8	78.8
Gross profit	18.1	20.1	21.2
Operating expenses:			
Research and development:			
Non-cash equity compensation	0.3	0.2	
Other	8.1	7.1	8.0
Selling, general and administrative:			
Non-cash equity compensation	0.5	0.4	0.1
Other	6.2	5.7	5.6
Amortization of intangible assets	0.8	0.5	0.5
In process research and development			0.5
Operating income	2.4	6.1	6.6
Net income from continuing operations	3.0%	5.9%	6.2%



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*Fiscal Year Ended November 30, 2007 Compared to Fiscal Year Ended November 30, 2006*

The following is a tabular presentation of our results of operations for our 2007 fiscal year compared to our 2006 fiscal year. Following the table is a discussion and analysis of our business and results of operations for such periods.

	<b>Year Ended November 30,</b>		<b>Increase/(Decrease)</b>	
	<b>2007</b>	<b>2006</b>	<b>Amount</b>	<b>%</b>
(US dollars in thousands)				
<b>Revenues:</b>				
Networked Storage Solutions	\$ 693,990	\$ 598,752	\$ 95,238	15.9%
Storage Infrastructure	237,643	384,881	(147,238)	(38.3)
<b>Total revenues</b>	<b>931,633</b>	<b>983,633</b>	<b>(52,000)</b>	<b>(5.3)</b>
Cost of revenues non cash equity compensation	1,238	923	315	
Cost of revenues other	761,344	785,424	(24,080)	(3.1)
<b>Gross profit:</b>				
Networked Storage Solutions	100,573	82,762	17,811	21.5
Storage Infrastructure	69,716	115,447	(45,731)	(39.6)
Non cash equity compensation	(1,238)	(923)	(315)	
<b>Total gross profit</b>	<b>169,051</b>	<b>197,286</b>	<b>(28,235)</b>	<b>(14.3)</b>
<b>Operating expenses:</b>				
Research and development non cash equity compensation	2,477	1,962	515	
Research and development other	75,082	69,429	5,653	8.1
Selling, general and administrative non cash equity compensation	4,342	4,309	33	
Selling, general and administrative other	57,635	56,140	1,495	2.7
Amortization of intangible assets	7,304	5,123	2,181	
Operating income	22,211	60,323	(38,112)	(63.2)
Other income	890	3,167	(2,277)	
Interest income, net	3,283	1,162	2,121	
Provision (benefit) for income taxes	(1,725)	6,474	(8,199)	
<b>Net income from continuing operations</b>	<b>\$ 28,109</b>	<b>\$ 58,178</b>	<b>\$ (30,069)</b>	<b>(51.7)%</b>

*Revenues*

The 5.3% decrease in our revenues in our 2007 fiscal year compared to 2006 fiscal year was attributable to decreased sales of our Storage Infrastructure products being partially offset by an increase in sales of our Networked Storage Solutions products.

The \$147.2 million or 38.3% decrease in revenues from sales of Storage Infrastructure products primarily related to a decrease in demand due to the investment by Seagate Technology in an exceptional level of production capacity in 2006 in connection with its acquisition of Maxtor as described in the overview. Reduced demand from Seagate for a range of our products was partially offset by increased demand from Western Digital for production test racks. As also described in the overview, 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.

Of the \$95.2 million, or 15.9%, increase in revenues from sales of our Networked Storage Solutions products, management estimates that \$65.4 million was contributed by an increase of 13% in



sales of our storage subsystem products incorporating Fibre Channel disk drives. The remaining increase related primarily to growth of approximately 25% in revenues from products incorporating low-cost 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.

*Cost of Revenues and Gross Profit*

The decrease in cost of revenues and gross profit in our 2007 fiscal year compared to our 2006 fiscal year was primarily due to lower Storage Infrastructure revenues as described above. As a percentage of revenues, our gross profit was 18.1% for our 2007 fiscal year compared to 20.1% for our 2006 fiscal year. This change was primarily attributable to the increased proportion of revenues from the sales of lower margin Networked Storage Solutions products.

The gross margin for our Networked Storage Solutions products increased to 14.5% in our 2007 fiscal year from 13.8% in our 2006 fiscal year as a result of a number of changes in product and customer mix, none of which were individually significant. These include the effect of improved margins on a number of newer products which now benefit from lower component costs.

The gross margin for Storage Infrastructure products decreased to 29.3% in our 2007 fiscal year, from 30.0% in our 2006 fiscal year. This was primarily a result of fixed costs relative to lower 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 \$1.2 million for our 2007 fiscal year and \$0.9 million for our 2006 fiscal year. See Note 16 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*

The \$6.2 million increase in research and development expense in our 2007 fiscal year compared to our 2006 fiscal year primarily related to increased investment in a number of our Storage Infrastructure product lines, particularly automation products, including that related to solar panel manufacturing. The increase also included approximately \$1.2 million resulting from a change in exchange rates and an increase in the number of employees supporting development of Networked Storage Solutions products. These effects were partially offset by a decrease in employee performance bonuses of \$1.4 million.

*Selling, General and Administrative*

The \$1.5 million increase in our selling, general and administrative expense in our 2007 fiscal year compared to our 2006 fiscal year primarily related to an increase of \$2.1 million resulting from a change in exchange rates, partially offset by a decrease in employee performance bonuses of \$1.6 million.

*Amortization of Intangible Assets*

The \$2.1 million increase in amortization of intangible assets in our 2007 fiscal year relates primarily to the effects of our acquisitions of patents and other specific intellectual property from IBM and Ario Data Networks Inc as described above.

*Other Income*

We recorded income of \$0.9 million in our 2007 fiscal year and \$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 \$3.3 million in our 2007 fiscal year compared with \$1.2 million in our 2006 fiscal year. This resulted primarily from an increase in average cash balances.

*Benefit (Provision) for Income Taxes*

During our 2007 fiscal year we recorded a benefit for income taxes of \$1.7 million compared with a provision for income taxes of \$6.5 million in our 2006 fiscal year. This was primarily as a result of a reduction in income before income taxes. Both periods included beneficial adjustments to prior year tax assets and liabilities. These amounted to approximately \$4.5 million and \$3.0 million in our 2007 and 2006 fiscal years, respectively. The 2007 fiscal year benefit also included additional income tax expense of \$1.4 million resulting from the effect of a reduction in U.K. income tax rates on the related deferred tax asset and a benefit of \$2.3 million relating to a change in exchange rates.

*Net Income from Continuing Operations*

The decrease in net income for our 2007 fiscal year compared to our 2006 fiscal year resulted primarily from a decrease in Storage Infrastructure revenues.

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*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.

	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
<b>Total revenues</b>	<b>983,633</b>	<b>679,609</b>	<b>304,024</b>	<b>44.7</b>
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)	
<b>Total gross profit</b>	<b>197,286</b>	<b>144,294</b>	<b>52,992</b>	<b>36.7</b>
<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)	
<b>Operating income</b>	<b>60,323</b>	<b>44,677</b>	<b>15,646</b>	<b>35.0</b>
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
<b>Net income from continuing operations</b>	<b>\$ 58,178</b>	<b>\$ 41,889</b>	<b>\$ 16,289</b>	<b>38.9%</b>

*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.

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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. In addition to underlying growth in demand, the increase in revenues resulted from an exceptional 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 a constraint in the supply of disk media. As explained in the overview this resulted in a level of surplus capacity and therefore revenue from Storage Infrastructure products declined in our 2007 fiscal year. Included in revenues in our 2006 fiscal year 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.

### *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, 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 16 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*

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 in September 2005 and Oliver Design in May 2005.

*In Process Research and Development*

In April 2005 we purchased intellectual property for \$2.2 million consisting of a software suite which we incorporated 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.

## Quarterly Results of Operations

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

	Three Months Ended							
	November 30, 2007	August 31, 2007	May 31, 2007	February 28, 2007	November 30, 2006	August 31, 2006	May 31, 2006	February 28, 2006
(unaudited) (U.S. dollars in thousands)								
Revenues	\$ 247,988	\$ 234,214	\$ 213,025	\$ 236,407	\$ 241,096	\$ 263,138	\$ 288,882	\$ 190,517
Cost of revenues non-cash equity compensation	356	310	327	245	280	282	253	108
Cost of revenues other	201,777	191,964	176,477	191,127	198,778	207,206	226,600	152,840
Gross profit	45,855	41,940	36,221	45,035	42,038	55,650	62,029	37,569
Operating expenses:								
Research and development non-cash equity compensation	711	620	655	491	557	586	534	285
Research and development other	18,659	19,567	18,554	18,303	16,909	17,475	18,868	16,177
Selling, general and administrative non-cash equity compensation	1,170	1,060	1,188	924	981	1,184	1,168	976
Selling, general and administrative other	15,362	15,001	13,396	13,876	14,886	14,580	14,787	11,892
Amortization of intangible assets	2,485	1,517	1,651	1,651	1,430	1,318	1,185	1,185
Total operating expenses	38,387	37,765	35,444	35,245	34,763	35,143	36,542	30,515
Operating income	7,468	4,175	777	9,790	7,275	20,507	25,487	7,054
Other income, net				890	1,202		1,965	
Interest income, net	1,030	824	774	655	295	429	233	205
Income before income taxes	8,498	4,999	1,551	11,335	8,772	20,936	27,685	7,259
Provision (benefit) for income taxes	(3,229)	733	(450)	1,221	(582)	3,125	3,109	822
Net income	\$ 11,727	\$ 4,266	\$ 2,001	\$ 10,114	\$ 9,354	\$ 17,811	\$ 24,576	\$ 6,437

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, bank borrowings and the net proceeds from our initial public offering.





*Cash flows*

Net cash provided by operating activities was \$41.3 million, \$54.5 million and \$38.6 million for our fiscal years ended November 30, 2007, 2006 and 2005 respectively.

Cash provided by operating activities of \$41.3 million for the 2007 fiscal year resulted primarily from the positive contribution of net income of \$28.1 million after excluding net non-cash charges totaling \$29.4 million together with an increase in accounts payable of \$11.1 million. These positive effects on cash flows were partially offset by increases in accounts receivable of \$17.0 million. The increase in accounts receivable and accounts payable primarily related to growth in our Networked Storage Solutions revenues. Other changes in working capital resulted in a cash out flow of \$10.3 million. These included the effects of a reduction in employee performance related bonuses of \$3.4 million and an increase in sales related tax recoverable of \$2.5 million.

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 resulted 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.

Net cash used in investing activities was \$23.5 million for our 2007 fiscal year, \$35.4 million for our 2006 fiscal year and \$51.9 million for our 2005 fiscal year.

Net cash used in investing activities for the 2007 fiscal year included a \$1.7 million final payment of deferred consideration related to our acquisition of ZT Automation in 2004, \$17.0 million related to capital expenditure and \$4.8 million related to the purchase of intellectual property from IBM and Ario Data Networks Inc as described in the overview above.

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

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 has resulted in additional capital expenditure of \$8.9 million in our 2005, 2006 and 2007 fiscal years, of which \$3.8 million, \$3.0 million and

\$2.1 million respectively is included in capital expenditure in our 2005, 2006 and 2007 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. 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 our financing activities was \$4.1 million in our 2007 fiscal year, \$3.4 million in our 2006 fiscal year and \$9.0 million in our 2005 fiscal year.

Net cash used in financing activities for the 2007 fiscal year comprises a final repayment of \$7.0 million of our HSBC term loan offset by \$2.9 million proceeds from the exercise of employee share options.

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.

#### *Liquidity*

As of November 30, 2007, our principal sources of liquidity consisted of cash and cash equivalents of \$70.7 million and our multi-currency credit facilities with HSBC. The facilities 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, 2007, 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.

On January 14, 2008 we commenced a share buy-back program. We have announced that we will purchase our common shares up to a value of \$30 million and it is anticipated that the repurchase will take place over a period of up to one year.

In addition to the share buy-back 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 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, 2007 that may affect our liquidity over the next five years:

	<b>Payments due by Period</b>				
	<b>Total</b>	<b>Less than 1 year</b>	<b>1-3 years</b>	<b>4-5 years</b>	<b>After 5 years</b>
(US dollars in thousands)					
Operating lease commitments	\$ 20,742	\$ 7,418	\$ 10,249	\$ 2,310	\$ 765
Purchase commitments	192,576	192,576			
<b>Total contractual cash obligations</b>	<b>\$ 213,318</b>	<b>\$ 199,994</b>	<b>\$ 10,249</b>	<b>\$ 2,310</b>	<b>\$ 765</b>

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.

**Off Balance Sheet Arrangements**

As of November 30, 2007, 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.

***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 deferred tax asset balance of \$22.7 million at November 30, 2007. We have determined that this amount is recoverable taking into account future taxable income and ongoing prudent and feasible tax planning strategies. Should we determine that we will, more likely than not, be able to realize a 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, a reduction to the deferred tax assets would decrease income in the period such determination was made. The deferred tax asset balance includes an amount of \$5.3 million which relates to the income tax deduction which may be obtained when employees exercise share options or when 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, 2007 were \$54.2 million, and any future write-downs of goodwill would adversely affect our operating margin.

### ***Revenue Recognition***

We recognize revenue in accordance with Securities and Exchange Commission ("SEC") Staff Accounting Bulletin ("SAB") No. 104, Revenue Recognition. Using this guidance, revenue from product sales is recognized once delivery has occurred provided that persuasive evidence of an arrangement exists, the price is fixed or determinable, and collectability is reasonably assured. Delivery is considered to have occurred when title and risk of loss have transferred to the customer.

Product sales relating to the Storage Infrastructure segment often include the provision of installation services. We therefore evaluate these sales as multiple-element arrangements in accordance with Emerging Issues Task Force Abstract ("EITF") 00-21, "Revenue Arrangements with Multiple Deliverables". A multiple-element arrangement is a transaction which may involve the delivery or performance of multiple products, services, or rights to use assets, and performance may occur at different points in time or over different periods of time.

For products produced according to our published specifications, where no installation is required or installation is deemed perfunctory and no substantive customer acceptance provisions exist, revenue is recognized when title passes to the customer, generally upon shipment. For products produced according to a particular customer's specifications, revenue for the product element is recognized when the product has been tested and it has been demonstrated that it meets the customer's specifications and title passes to the customer, provided also that there is objective and reliable evidence of the fair value of the installation or the fair value is determined to be insignificant and where installation is not deemed to be essential to the functionality of the equipment. For new products, new applications of existing products, products where there is no objective and reliable evidence of the fair value of the installation or for products with substantive customer acceptance provisions where performance cannot be fully assessed prior to meeting customer specifications at the customer site, revenue is recognized upon completion of installation and receipt of final customer acceptance.

In certain instances, we require advanced deposits for a portion of the sales price in advance of shipment. These amounts are recorded as deferred revenue until the revenue recognition criteria above are met.

Revenue from services other than installation is recognized as services are rendered and accepted by the customer.

A number of our contracts for the supply of products have included payments upon the achievement of substantive milestones for Non-Recurring Engineering ("NRE") during the product development phase. For these contracts, the product development phase constituted a separate earnings process and revenue relating to the NRE payments received has been recognized upon the achievement of the applicable milestones. Up-front fees received on execution of a contract are recognized over the estimated contract life. Revenue related to NRE payments amounted to approximately \$1.2 million, \$1.9 million and \$0.8 million in our 2007, 2006 and 2005 fiscal years respectively.

Particularly in connection with sales in of our Storage Infrastructure products where there are multiple element arrangements, recognition of revenue requires the judgment of management regarding, for example, whether the products meets customer specification, whether elements or contracts can be separated and when customer acceptance has occurred. Different judgments would result in changes to the level of revenue and income in a particular period.

***Share Based Payment***

Our equity compensation expense is calculated using FAS 123R. This calculation requires management to make a number of assumptions, estimates and accounting policy choices. These include the use of the Black-Scholes option pricing model as our method of valuation for share options which were granted in 2005 and prior periods. 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. The expense related to the grant of Restricted Stock Units in 2006 and 2007 requires less judgment than that related to options, but does require management judgment regarding the achievement of performance conditions, expected forfeiture levels and date of grant.

***Recent Accounting Pronouncements***

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 ("FAS 157"), "Fair Value Measurements". 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.

In February 2007, the FASB issued FAS No. 159 ("FAS 159"), "The Fair Value Option for Financial Assets and Financial Liabilities" including an amendment of FAS No. 115". FAS 159 allows measurement at fair value of eligible financial assets and liabilities that are not otherwise measured at fair value. If the fair value option for an eligible item is elected, unrealized gains and losses for that item shall be reported in current earnings at each subsequent reporting date. FAS 159 also establishes presentation and disclosure requirements designed to draw comparison between the different measurement attributes the company elects for similar types of assets and liabilities. This statement is effective for fiscal years beginning after November 15, 2007. We are in the process of evaluating the effect FAS 159 may have on our consolidated financial statements.

In December 2007, the FASB issued FAS No. 141 (Revised 2007), "Business Combinations". FAS 141R retains the fundamental requirements of the original pronouncement requiring that the purchase method be used for all business combinations. FAS 141R defines the acquirer as the entity that obtains control of one or more businesses in the business combination, establishes the acquisition date as the date that the acquirer achieves control and requires the acquirer to recognize the assets acquired, liabilities assumed and any noncontrolling interest at their fair values as of the acquisition date. In addition, FAS 141R requires expensing of acquisition-related and restructure-related costs, remeasurement of earn out provisions at fair value, measurement of equity securities issued for purchase at the date of close of the transaction and non-expensing of in-process research and development related intangibles. FAS 141R is effective for our business combinations for which the acquisition date is on or after December 1, 2009.

**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:

<b>Name</b>	<b>Age</b>	<b>Position</b>
Steve Barber	47	Chief Executive Officer
Richard Pearce	37	Chief Financial Officer
Adam Wray	40	Executive Vice President
Todd Gresham	47	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 and a member of our board of directors. 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. 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.

*Adam Wray* is our Executive Vice President of our Storage Infrastructure division. 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 plus 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 our Networked Storage Solutions division. Mr. Gresham previously served as a Senior Vice President within the business. In that role, 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 after EMC's acquisition of Data General's CLARiiON storage division. While with CLARiiON, Mr. Gresham held multiple positions including general manager of Asia/Pacific operations, as well as Vice President of World Wide Sales. Prior, Mr. Gresham held various executive positions with 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	52	Chairman
Steve Barber	47	Director
Jonathan Brooks	52	Director
Richard Pearce	37	Director
Ernest Sampias	56	Director
Steve Sanghi	52	Director
Mike Windram	62	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 also a non-executive director of Zesko Holding B.V. 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.

*Jonathan Brooks* has served as a director on our board of directors since May 1, 2004. Mr. Brooks is currently a director of e2v Technologies plc, which develops sensor technology, and Aveva Group plc, a leading software provider to the plant, power and marine industries, both of which are listed on the LSE. He is also Chairman of Picochip Inc., a private equity backed company developing semiconductor solutions for wireless applications and a director of Sophos Plc, an enterprise IT security and control company. 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.

*Richard Pearce.* As above.

*Ernest Sampias* has served as a director on our board of directors since May 1, 2004. He is the Chief Financial Officer for Sensis Pty Ltd, in Melbourne, Australia. His previous experience includes financial roles for both private and public companies within the information technologies, telecommunications, and directories industries, These financial roles were as Chief Financial Officer for SpectraLink Corporation, McDATA Corporation, US West Dex, Local Matters, Inc., and Convergent Communications, Inc. Mr. Sampias graduated from Indiana University with a Bachelors of Science degree in Business with distinction, and holds a Masters of Taxation degree from DePaul University in Chicago. He is a Certified Public Accountant and a member in the Financial Executives Institute and American Institute of Certified Public Accountants.

*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.

*Mike Windram* has served as a director on our board of directors since June 2007. He has over 30 years of experience in research and development, engineering and engineering management roles. His early experience from 1971 to 1990 was in research and development in the Independent Broadcasting Authority. Subsequently he has held the positions of Executive Manager (R&D) in NTL, Director, Advanced Products Division, NTL, Managing Director, Digi-Media Vision (DMV) Ltd, Managing Director, NDS Broadcast and Senior Vice President, NDS. These divisions and companies provided systems, equipment and software for use in digital broadcasting applications world-wide. His most recent position was as a member of the board of Tandberg Television ASA. Dr Windram graduated from the University of Cambridge with a Bachelor of Arts degree in Natural Sciences (Physics) and also holds Master of Arts and Doctor of Philosophy degrees from that university. He is a Fellow of the Royal Academy of Engineering, a Fellow of the Institution of Engineering and Technology and a Chartered Engineer.

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**

### **Chairman and Non-executive Director Compensation**

We paid our Chairman and non-executive directors (consisting of 5 persons) an aggregate amount of \$386,000 for the fiscal year ending November 30, 2007 for fees. In addition, during our fiscal year ended November 30, 2007, we have also awarded our chairman and non-executive directors 21,000 restricted stock units (RSUs) 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, has been paid to executive directors in respect of their role as a director.

### **Executive Compensation**

The aggregate compensation paid to the four executive officers of Xyratex Ltd for the fiscal year ending November 30, 2007 was \$1,862,000 (of which \$1,276,000 comprised salary, \$102,000 comprised non-cash payments and \$484,000 comprised bonus payments). In addition, during our fiscal year ended November 30, 2007, in aggregate we have also awarded four executive officers 60,000 RSUs in respect of Xyratex Ltd common shares of which 45,000 became eligible vesting RSUs on February 1, 2008, based on performance criteria.

At the end of our 2007 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 7 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 2010;

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, Ernest Sampias and Mike Windram; Class II consists of Steve Barber and Jonathan Brooks; and Class III consists of Steve Sanghi and Richard Pearce. 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 (Chairman), 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 two times during the fiscal year ended November 30, 2007. 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 (Chairman), Jonathan Brooks and Mike Windram, each of whom satisfy the "independence" requirements of the Nasdaq Corporate

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Governance Rules. Steve Sanghi was a member of the Committee until January 7, 2008 when he was replaced by Mike Windram. The Audit Committee met eight times during the fiscal year ended November 30, 2007. 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 consists of Andrew Sukawaty (Chairman), 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, 2007 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, 2007, we employed 1,619 permanent employees worldwide and an additional 430 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.

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

	2007	2006	2005
Operations	795	759	747
Research and development	421	401	386
Sales, marketing and service	220	234	140
General and administration	183	163	132
<b>Total</b>	<b>1,619</b>	<b>1,557</b>	<b>1,405</b>
Total employees in the United States	551	548	497
Total employees in Asia	509	489	404
Total employees in the United Kingdom	559	520	502

### 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, 2007. 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(1)	Options			
				Number(1)	Exercise Price Per Share	Expiration Date	
Steve Barber	512,129	1.76%	42,750	31,091	£	1.447	March 29, 2011
				72,546	£	1.447	April 22, 2012
				100,000	\$	14.31	January 9, 2015
Richard Pearce	96,120	<1%	21,375	4,318	£	1.447	March 29, 2011
				51,818	£	2.653	July 22, 2012
				55,000	\$	14.31	January 9, 2015
Adam Wray	18,731	<1%	21,375	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			46,667	37,500	\$	13.51	October 31, 2015
Andrew Sukawaty	107,275	<1%	7,000	228,003	\$	14.47	March 30, 2014
Jonathan Brooks	1,750	<1%	5,250	20,000	\$	14.00	June 28, 2014
				5,000	\$	14.31	January 9, 2015
Ernest Sampias	4,250	<1%	5,250	10,000	\$	14.00	June 28, 2014
Steve Sanghi	1,750	<1%	5,250	10,000	\$	14.00	June 28, 2014
Mike Windram			3,500				
All our directors and executive officers as a group (nine persons)	742,005	2.55%					

(1) All options and RSUs entitle the holder to acquire one common share for each option or unit 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.

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

Xyratex Ltd and Credit Suisse, 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, 2008, awards over 2,526,000 of our common shares had been granted since our initial public offering.

### *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.

### *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.

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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.

At December 31, 2007, 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.

### *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.

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.

*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.

*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*

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, 2007 no restricted stock awards were outstanding.

*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, 2007, no stock bonus awards have been made.

***Xyratex Group Limited Share Option Plan***

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 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.

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The following table contains a summary of all options that have been granted under the Company's share option plans and are outstanding as of November 30, 2007:

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		77,344	77,344
The Xyratex Ltd Unapproved Plan		481,770	481,770
The Approved Plan	235,505	31,091	266,596
The Unapproved Schedule	62,538	302,421	364,959
The 2004 Plan		302,973	302,973
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) 112,079 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
Artisan Partners Ltd	December 31, 2007	2,527,400	8.7%
FMR, LLC	December 31, 2007	2,528,020	8.8%
Price T Rowe Associates, Inc	December 31, 2007	2,883,200	9.9%
Renaissance Technologies, LLC	June 18, 2007	1,913,270	6.6%
Silver Point Capital, L.P.	January 3, 2008	3,500,000	12.0%

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

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



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As of January 31, 2008, the number of shares of Xyratex Ltd held of record in the United States was 28,006,808 common shares, held by 244 record holders, representing 96.2% 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 sold our U.K. property in 2000 to Havant International Limited as part of a demerger of a predecessor holding company. As part of the demerger we continued to occupy part of this property and the terms of the lease to be entered into were agreed. Based on this arrangement, on June 10, 2002, Havant International Limited, which at that time was under substantially common ownership, 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 space. Subsequently we have entered into lease agreements for an additional 25,000 square feet. The terms of these agreements also include the provision of certain services relating to the property, such as security, maintenance, property insurance, conference facilities and catering. The prices for these services are based on cost and are negotiated at least annually. We continue to occupy this property and although the current owner of this property and the provider of these services are not related parties at November 30, 2007 the terms of the leases were agreed when they were under substantially common ownership. The amount payable under these agreements in our 2007 fiscal year totaled \$4.6 million. We have recently 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, 2007, the Trust held 298,043 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**

None.

**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, 2008, the market price for our common shares was \$18.05.

**Annual high and low market prices**

The table below states the annual high and low market prices for our common shares on The NASDAQ Stock Market LLC since our IPO in 2004.

Year ending November 30,	NASDAQ	
	U.S. dollar per common share	
	High	Low
2004	\$ 15.05	\$ 6.85
2005	\$ 21.87	\$ 12.50
2006	\$ 33.63	\$ 15.63
2007	\$ 24.75	\$ 14.05

**Quarterly high and low market prices**

The table below states for the four quarters of our 2007 and 2006 fiscal years, high and low prices of our common shares on The NASDAQ Stock Market LLC.

Quarter	NASDAQ	
	U.S. dollar per common share	
	High	Low
<b>Quarter 2007</b>		
First	\$ 24.14	\$ 19.40
Second	\$ 24.75	\$ 20.50
Third	\$ 24.01	\$ 18.18
Fourth	\$ 21.18	\$ 14.05
<b>Quarter 2006</b>		
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 six months.

Month	NASDAQ	
	U.S. dollar per common share	
	High	Low
August 2007	\$ 22.41	\$ 18.18
September 2007	\$ 21.18	\$ 18.00
October 2007	\$ 19.50	\$ 16.67

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	NASDAQ			
	<hr/>			
November 2007	\$	17.08	\$	14.05
December 2007	\$	15.94	\$	14.20
January 2008	\$	18.11	\$	13.34

**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, 2007 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 rates on cash and cash equivalents.

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, 2007 we had \$16.7 million net U.K. pound denominated assets including a \$12.4 million deferred tax asset. A hypothetical 10% movement in exchange rates at November 30, 2007 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, 2007 and November 30, 2006:

<b>Derivatives between U.K. pound and U.S. dollar</b>	<b>November 30,</b>	
	<b>2007</b>	<b>2006</b>
Forward exchange contracts	\$ 63,344	\$ 43,294
Fair value of contracts asset (liability)	\$ 2,440	\$ 3,762
Carrying value of contracts asset (liability)	\$ 2,440	\$ 3,762
Average rate of contract	\$ 1.98	\$ 1.80
Period end rate	\$ 2.06	\$ 1.95
Maximum period of contracts (months)	12	12

  

<b>Derivatives between Malaysian Ringgit and U.S. dollar</b>	<b>November 30,</b>	
	<b>2007</b>	<b>2006</b>
Forward exchange contracts and options	\$ 5,000	\$ 6,500
Fair value of contracts asset (liability)	\$ 196	\$ 46
Carrying value of contracts asset (liability)	\$ 196	\$ 46
Average rate of contract	\$ 0.29	\$ 0.28
Period end rate	\$ 0.29	\$ 0.28
Maximum period of contracts (months)	12	12

Since November 30, 2007, 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, 2007 totaling \$70.7 million. These are primarily held in variable interest liquidity funds and overnight deposits.

For the year ended November 30, 2007 we had average variable rate cash and cash equivalent balances, net of variable rate borrowings, of approximately \$59.8 million. A hypothetical 1% change in interest rates during our 2007 fiscal year would have impacted our net interest income by approximately \$0.6 million.

Since November 30, 2007, 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.

**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 of 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.

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The effectiveness of internal control over financial reporting as of November 30, 2007 has been audited by PricewaterhouseCoopers LLP, our independent registered public accounting firm, as stated in their report which is included on pages F-1 to F-2.

### *Changes in Internal Control over Financial Reporting*

There have been no significant changes in the Company's internal controls over financial reporting during the fiscal year ended 30 November 2007 that have materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

### *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 16: OTHER INFORMATION**

### **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 available on the Company's website.

**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, 2007:

	Year ended November 30,	
	2007	2006
	(U.S. dollars in thousands)	
Audit Fees(1)	\$ 792	\$ 636
Audit-related fees(2)	19	6
Tax fees(3)	282	230
Total fees	\$ 1,093	\$ 872

- (1) Represents fees for professional services related to the audit of our annual consolidated financial statements for years ended November 30, 2007 and 2006, 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 in 2006 and responding to an SEC comment letter received during 2007.
- (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 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.

The Audit Committee approved 100% of the non-audit fees billed by our principal accountants in the year ended November 30, 2007 under these policies and procedures.

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

Not applicable.

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

None.

**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:

	<b>Page</b>
<u>Report of Independent Registered Public Accounting Firm</u>	F-1
<u>Audited Consolidated Balance Sheets as of November 30, 2007 and 2006</u>	F-3
<u>Audited Consolidated Statements of Operations for each of the three years in the period ended November 30, 2007</u>	F-4
<u>Audited Consolidated Statements of Shareholders' Equity and Comprehensive Income for each of the three years in the period ended November 30, 2007</u>	F-5
<u>Audited Consolidated Statements of Cash Flows for each of the three years in the period ended November 30, 2007</u>	F-6
<u>Notes to the Audited Consolidated Financial Statements</u>	F-7

**ITEM 19: EXHIBITS**

Exhibit Number	Description
1.1	Memorandum of Association of Xyratex Ltd*
1.2	Bye-Laws of Xyratex Ltd**
8	Subsidiaries of Xyratex Ltd**
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	Schedule II Valuation and Qualifying Accounts and Reserves

\*

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

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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 20, 2008

By: /s/ STEVE BARBER

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Chief Executive Officer

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**XYRATEX LTD**

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the 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, 2007 and 2006, and the results of their operations and their cash flows for each of the three years in the period ended November 30, 2007 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedule in exhibit 15.1 presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of November 30, 2007, based on criteria established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for these financial statements, and the financial statement schedule in exhibit 15.1, for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included under "Item 15: Controls and Procedures".

Our responsibility is to express opinions on these financial statements, on the financial statement schedule in exhibit 15.1 and on the Company's internal control over financial reporting based on our audits (which was an integrated audit in 2007). We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included 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. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

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.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's 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 the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

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Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

PRICEWATERHOUSECOOPERS LLP

PricewaterhouseCoopers LLP  
Southampton  
England  
February 20, 2008

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## XYRATEX LTD

## AUDITED CONSOLIDATED BALANCE SHEETS

	November 30,	
	2007	2006
	(US dollars and amounts in thousands)	
<b>ASSETS</b>		
<b>Current assets:</b>		
Cash and cash equivalents	\$ 70,678	\$ 56,921
Accounts receivable, net of allowance for doubtful accounts of \$434 and \$411	122,327	105,324
Inventories	91,662	93,111
Prepaid expenses	2,994	2,390
Deferred income taxes	3,000	2,513
Other current assets	8,275	7,247
<b>Total current assets</b>	<b>298,936</b>	<b>267,506</b>
Property, plant and equipment, net	37,421	34,471
Intangible assets, net	54,175	58,109
Deferred income taxes	19,743	15,594
<b>Total assets</b>	<b>\$ 410,275</b>	<b>\$ 375,680</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>Current liabilities:</b>		
Accounts payable	\$ 96,046	\$ 84,896
Short-term borrowings		4,000
Employee compensation and benefits payable	13,280	16,645
Deferred revenue	15,212	16,303
Income taxes payable	1,165	1,641
Other accrued liabilities	11,311	14,701
<b>Total current liabilities</b>	<b>137,014</b>	<b>138,186</b>
Long-term debt		3,000
<b>Total liabilities</b>	<b>137,014</b>	<b>141,186</b>
<b>Commitments and contingencies (note 14)</b>		
<b>Shareholders' equity</b>		
Common shares of Xyratex Ltd (in thousands), par value \$0.01 per share 70,000 authorized, 29,117 and 28,793 issued and outstanding	291	288
Additional paid-in capital	356,268	344,686
Accumulated other comprehensive income	1,847	2,774
Accumulated deficit	(85,145)	(113,254)
<b>Total shareholders' equity</b>	<b>273,261</b>	<b>234,494</b>
<b>Total liabilities and shareholders' equity</b>	<b>\$ 410,275</b>	<b>\$ 375,680</b>

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





## XYRATEX LTD

## AUDITED CONSOLIDATED STATEMENTS OF OPERATIONS

Year Ended November 30,

	2007	2006	2005
(US dollars and amounts in thousands except per share amounts)			
Revenues	\$ 931,633	\$ 983,633	\$ 679,609
Cost of revenues non cash equity compensation	1,238	923	
Cost of revenues other	761,344	785,424	535,315
	<u>762,582</u>	<u>786,347</u>	<u>535,315</u>
Gross profit	169,051	197,286	144,294
Operating expenses:			
Research and development non cash equity compensation	2,477	1,962	
Research and development other	75,082	69,429	54,327
Selling, general and administrative non cash equity compensation	4,342	4,309	828
Selling, general and administrative other	57,635	56,140	38,014
Amortization of intangible assets	7,304	5,123	3,218
In process research and development			3,230
	<u>146,840</u>	<u>136,963</u>	<u>99,617</u>
Operating income	22,211	60,323	44,677
Other income	890	3,167	
Interest income	3,586	1,773	1,744
Interest expense	(303)	(611)	(568)
	<u>26,384</u>	<u>64,652</u>	<u>45,853</u>
Income from continuing operations before income taxes	26,384	64,652	45,853
Provision (benefit) for income taxes	(1,725)	6,474	3,964
	<u>28,109</u>	<u>58,178</u>	<u>41,889</u>
Net income from continuing operations	28,109	58,178	41,889
Income from discontinued operations (net of taxes)			280
	<u>28,109</u>	<u>58,178</u>	<u>42,169</u>
Net income	\$ 28,109	\$ 58,178	\$ 42,169
Net earnings per share basic:			
Net income from continuing operations	\$ 0.97	\$ 2.03	\$ 1.48
Income from discontinued operations, net of income tax			0.01
	<u>\$ 0.97</u>	<u>\$ 2.03</u>	<u>\$ 1.49</u>
Net earnings per share	\$ 0.97	\$ 2.03	\$ 1.49
Net earnings per share diluted:			
Net income from continuing operations	\$ 0.94	\$ 1.97	\$ 1.44
Income from discontinued operations, net of income tax			0.01
	<u>\$ 0.94</u>	<u>\$ 1.97</u>	<u>\$ 1.44</u>

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Year Ended November 30,

Net earnings per share	\$ 0.94	\$ 1.97	\$ 1.45
Weighted average common shares (in thousands), used in computing net earnings per share:			
Basic	28,985	28,663	28,329
Diluted	29,866	29,604	29,031

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

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## XYRATEX LTD

AUDITED CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY  
AND COMPREHENSIVE INCOME (LOSS)

(US dollars and amounts, in thousands)

	Number of Common Shares	Par value	Additional paid-in capital	Accumulated deficit	Accumulated other comprehensive income (loss)	Total
<b>Balances as of November 30, 2004</b>	<b>28,043</b>	<b>\$ 280</b>	<b>\$ 329,267</b>	<b>\$ (213,601)</b>	<b>\$ 755</b>	<b>\$ 116,701</b>
Issuance of common shares	394	4	2,171			2,175
Non-cash equity compensation			2,304			2,304
Employee bonus paid by trust			144			144
Components of comprehensive income, net of tax:						
Net income				42,169		
Unrealized loss on forward foreign currency contracts net of reclassification adjustment:					(2,111)	
Total comprehensive income						40,058
<b>Balances as of November 30, 2005</b>	<b>28,437</b>	<b>\$ 284</b>	<b>\$ 333,886</b>	<b>\$ (171,432)</b>	<b>\$ (1,356)</b>	<b>\$ 161,382</b>
Issuance of common shares	356	4	3,606			3,610
Non-cash equity compensation			7,194			7,194
Components of comprehensive income, net of tax:						
Net income				58,178		
Unrealized gain on forward foreign currency contracts net of reclassification adjustment:					4,130	
Total comprehensive income						62,308
<b>Balances as of November 30, 2006</b>	<b>28,793</b>	<b>\$ 288</b>	<b>\$ 344,686</b>	<b>\$ (113,254)</b>	<b>\$ 2,774</b>	<b>\$ 234,494</b>
Issuance of common shares	324	3	2,902			2,905
Non-cash equity compensation			8,057			8,057
Tax benefit from exercise of stock options			623			623
Components of comprehensive income, net of tax:						
Net income				28,109		
Unrealized gain on forward foreign currency contracts net of reclassification adjustment:					(927)	
Total comprehensive income						27,182
<b>Balances as of November 30, 2007</b>	<b>29,117</b>	<b>\$ 291</b>	<b>\$ 356,268</b>	<b>\$ (85,145)</b>	<b>\$ 1,847</b>	<b>\$ 273,261</b>

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

## XYRATEX LTD

## AUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS

	Year Ended November 30,		
	2007	2006	2005
	(US dollars in thousands)		
<b>Cash flows from operating activities:</b>			
Net income from continuing operations	\$ 28,109	\$ 58,178	\$ 41,889
Adjustments to reconcile net income from continuing operations to net cash provided by operating activities:			
Depreciation	13,683	10,105	6,694
Amortization of intangible assets	7,304	5,123	3,218
Non-cash equity compensation	8,057	7,194	828
Bonus paid by trust			144
In process research and development			3,230
Loss on sale of assets	341	265	90
Changes in assets and liabilities, net of impact of acquisitions and divestitures			
Accounts receivable	(17,003)	(21,098)	(29,272)
Inventories	1,449	(21,528)	(16,297)
Prepaid expenses and other current assets	(2,956)	1,138	(542)
Accounts payable	11,150	4,302	25,668
Employee compensation and benefits payable	(3,365)	3,025	2,474
Deferred revenue	(1,091)	(131)	(2,560)
Income taxes payable	(476)	80	(643)
Deferred income taxes	(1,616)	5,824	4,403
Other accrued liabilities	(2,266)	2,016	(986)
Net cash provided by operating activities of discontinued operations			280
Net cash provided by operating activities	41,320	54,493	38,618
<b>Cash flows from investing activities:</b>			
Investments in property, plant and equipment	(16,974)	(19,932)	(17,070)
Dispositions of property, plant and equipment		762	
Acquisition of intangible assets	(4,833)	(4,000)	
Acquisition of business, net of cash received	(1,661)	(12,252)	(34,845)
Net cash used in investing activities	(23,468)	(35,422)	(51,915)
<b>Cash flows from financing activities:</b>			
Net payments of short-term borrowings	(7,000)	(4,000)	(9,133)
Repayment of acquisition notes payable		(3,000)	(2,000)
Proceeds from issuance of shares	2,905	3,610	2,175
Net cash used in financing activities	(4,095)	(3,390)	(8,958)
Change in cash and cash equivalents	13,757	15,681	(22,255)
Cash and cash equivalents at beginning of period continuing operations	56,921	41,240	63,495
Cash and cash equivalents at end of period continuing operations	\$ 70,678	\$ 56,921	\$ 41,240

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



XYRATEX LTD

NOTES TO AUDITED CONSOLIDATED FINANCIAL STATEMENTS

(U.S. dollars and amounts in thousands, except per share data, unless otherwise stated)

**1. The Company and its Operations**

*Operations.* We are a leading provider of modular enterprise-class data storage solutions and storage process technology with principal operations in the United Kingdom ("U.K."), the United States of America ("U.S.") and Malaysia. We operate in two business segments: Networked Storage Solutions (NSS) and Storage Infrastructure (SI). Our NSS products are hard disk drive based data storage subsystems. Our SI products include disk drive production test systems, process automation for disk drive and solar panel manufacturing, servo track writers and disk cleaning systems.

*Parent company.* Xyratex Ltd, a company incorporated in Bermuda is our parent company. In these notes Xyratex Ltd together with its subsidiaries is referred to as the "Company".

**2. Basis of Presentation and Summary of Significant Accounting Policies**

A summary of the significant accounting policies followed in the preparation of the accompanying consolidated financial statements, which conform to accounting principles generally accepted in the United States, is presented below.

*Fiscal year.* The Company's fiscal year ends on November 30.

*Principles of consolidation.* The consolidated financial statements include the accounts of Xyratex Ltd and its wholly and majority-owned subsidiaries. Wholly and majority-owned subsidiaries are all entities over which the Company has the power to control the entity's financial and operating policies. All significant intercompany accounts and transactions have been eliminated.

*Use of estimates.* The preparation of the consolidated financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amount of revenues and expenses during the reporting periods. Some of the more significant estimates include inventory valuation reserves, depreciation, amortization and impairment of long-lived assets, deferred tax asset valuation allowance, warranty reserves and equity compensation expense. Actual results could differ from those estimates.

*Foreign currency.* The U.S. dollar is the functional currency of all operations as most revenues and expenses are incurred in U.S. dollars. As such, non-monetary assets and liabilities of operations located outside of the U.S. are remeasured into U.S. dollars using historical exchange rates. Monetary assets and liabilities are remeasured using the current rate at each balance sheet date. Revenue and expenses are generally translated at a monthly exchange rate, being the actual rate at the beginning of each month, except for those expenses related to balance sheet amounts that are remeasured at historical exchange rates. Gains or losses from foreign currency remeasurement are included in current income. Net foreign currency remeasurement gains of \$322, \$533 and \$500 are included in selling general and administrative other, in the years ended November 30, 2007, 2006 and 2005, respectively. Net foreign currency remeasurement gains of \$2,349, \$nil and \$nil are included in provision (benefit) for income taxes in the years ended November 30, 2007, 2006 and 2005, respectively.

*Comprehensive income (loss).* In addition to net income, comprehensive income (loss) includes charges or credits to equity that are not the result of transactions with shareholders. For the Company,

XYRATEX LTD

NOTES TO AUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(U.S. dollars and amounts in thousands, except per share data, unless otherwise stated)

**2. Basis of Presentation and Summary of Significant Accounting Policies (Continued)**

this includes unrealized gains and losses on forward foreign currency contracts and foreign currency options. The Company has included components of comprehensive income (loss) within the Consolidated Statements of Shareholders' Equity and Comprehensive Income (Loss).

*Revenue recognition.* The Company recognizes revenue in accordance with Securities and Exchange Commission ("SEC") Staff Accounting Bulletin ("SAB") No. 104, Revenue Recognition. Using this guidance, revenue from product sales is recognized once delivery has occurred provided that persuasive evidence of an arrangement exists, the price is fixed or determinable, and collectibility is reasonably assured. Delivery is considered to have occurred when title and risk of loss have transferred to the customer.

Product sales relating to the Storage Infrastructure segment often include the provision of installation services. We therefore evaluate these sales as multiple-element arrangements in accordance with Emerging Issues Task Force Abstract ("EITF") 00-21, "Revenue Arrangements with Multiple Deliverables". A multiple-element arrangement is a transaction which may involve the delivery or performance of multiple products, services, or rights to use assets, and performance may occur at different points in time or over different periods of time.

For products produced according to the Company's published specifications, where no installation is required or installation is deemed perfunctory and no substantive customer acceptance provisions exist, revenue is recognized when title passes to the customer, generally upon shipment. For products produced according to a particular customer's specifications, revenue for the product element is recognized when the product has been tested and it has been demonstrated that it meets the customer's specifications and title passes to the customer, provided also that there is objective and reliable evidence of the fair value of the installation or the fair value is determined to be insignificant and where installation is not deemed to be essential to the functionality of the equipment. For new products, new applications of existing products, products where there is no objective and reliable evidence of the fair value of the installation or for products with substantive customer acceptance provisions where performance cannot be fully assessed prior to meeting customer specifications at the customer site, revenue is recognized upon completion of installation and receipt of final customer acceptance.

In certain instances, the Company requires advanced deposits for a portion of the sales price in advance of shipment. These amounts are recorded as deferred revenue until the revenue recognition criteria above are met.

Revenue from services other than installation is recognized as services are rendered and accepted by the customer.

A number of the Company's contracts for the supply of products have included payments upon the achievement of substantive milestones for Non-Recurring Engineering ("NRE") during the product development phase. For these contracts, the product development phase constituted a separate earnings process and revenue relating to the NRE payments received has been recognized upon the achievement of the applicable milestones. Up-front fees received on execution of a contract are recognized over the estimated contract life. Revenue related to NRE payments amounted to approximately \$1,210, \$1,861 and \$757 in the years ended November 30, 2007, 2006 and 2005 respectively.

XYRATEX LTD

NOTES TO AUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(U.S. dollars and amounts in thousands, except per share data, unless otherwise stated)

**2. Basis of Presentation and Summary of Significant Accounting Policies (Continued)**

*Research and development.* Amounts spent by the Company for research and development efforts are recorded as research and development expenses when incurred.

*Warranty expense.* The Company generally offers warranties between one and three years. Estimated future warranty obligations related to product sales are charged to operations in the period in which the related revenue is recognized. These estimates are based on historical warranty experience and other relevant information of which the Company is aware. During the years ended November 30, 2007, 2006 and 2005, warranty expense was \$3,099, \$3,280 and \$2,046 respectively.

*Shipping and handling costs.* Shipping and handling costs charged to customers are included in revenues and the associated expense is recorded in cost of revenues for all periods presented.

*Advertising.* Advertising costs are expensed as incurred and amounted to \$15, \$29 and \$21 during the years ended November 30, 2007, 2006, and 2005, respectively.

*Pensions and 401(k) plan.* Retirement benefits are provided for UK and Malaysian employees by defined contribution pension plans whereby the assets of the plans are held separately from those of the Company and are independently administered. The Company also makes contributions to a 401(k) savings plan for U.S. employees. Contributions by the Company to defined contribution pension plans are charged to current income as they become payable and amounted to \$4,634, \$4,685 and \$3,572 during the years ended November 30, 2007, 2006 and 2005, respectively.

*Equity compensation.* On December 1, 2005, the Company adopted Statement of Financial Accounting Standards No.123 (revised 2004), "Share-Based Payment" ("FAS 123R"), which requires the measurement and recognition of compensation for all share-based awards made to employees and directors including share options and employee share purchases under a share purchase plan based on estimated fair values. FAS 123R supersedes previous accounting under Accounting Principles Board Opinion No.25, "Accounting for Stock Issued to Employees" ("APB 25") for periods beginning in the Company's 2006 fiscal year. In March 2005, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 107 relating to application of FAS 123R.

The Company adopted FAS 123R using the modified prospective transition method, which requires the application of the accounting standard as of December 1, 2005. In accordance with the modified prospective transition method, the Company's consolidated financial statements for previous periods have not been restated to reflect this change. Equity compensation recognized during the period is based on the graded vesting of the share-based award, adjusted for expected forfeitures. Equity compensation recognized in the Company's consolidated financial statements for the year ended November 30, 2007 includes compensation cost for share-based awards granted prior to, but not fully vested as of, November 30, 2005 and share-based awards granted subsequent to November 30, 2005.

In the years ended November 30, 2006 and 2007 the Company's share based awards were in the form of Restricted Stock Units ("RSU"). The valuation of these awards is based on the share price on the date of grant and requires the estimate of forfeiture levels and the achievement of performance conditions.

Upon adoption of FAS 123R, the Company used the Black-Scholes option pricing model as the method of valuation for share options which have previously been awarded. The determination of the



XYRATEX LTD

NOTES TO AUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(U.S. dollars and amounts in thousands, except per share data, unless otherwise stated)

**2. Basis of Presentation and Summary of Significant Accounting Policies (Continued)**

fair value of share-based awards on the date of grant using an option pricing model is affected by the Company's share price as well as assumptions regarding a number of highly complex and subjective variables. These variables include, but are not limited to the Company's expected share price volatility over the term of the award, expected forfeiture levels and actual and projected exercise behaviors. Although the fair value of share-based awards is determined in accordance with FAS 123R and SAB 107, the Black-Scholes option pricing model requires the input of highly subjective assumptions, and other reasonable assumptions could provide differing results.

*Income taxes.* Provision for income taxes is based on income before taxes. Deferred tax assets and liabilities are recognized principally for the expected tax consequences of temporary differences between the tax bases of assets and liabilities and their reported amounts. Deferred tax assets also arise from net operating losses and are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to reverse. Valuation allowances are established when necessary to reduce the deferred tax assets to the amount more likely than not to be realized.

*Net earnings per share.* Basic net earnings per share is computed by dividing net income by the weighted-average number of common shares outstanding, during the period, excluding the dilutive effect of share options and RSUs. Diluted net earnings per share gives effect to all potentially dilutive common share equivalents outstanding during the period including RSUs and share options.

*Cash and cash equivalents.* Investments are classified as cash equivalents if their original maturity is three months or less. Cash equivalents are stated at cost, which approximates fair value.

*Accounts receivable.* Accounts receivable are stated at cost less the allowance for doubtful amounts. No interest has been charged on accounts receivable.

*Inventory.* Inventory is valued at standard cost, which approximates actual cost computed on a first-in, first-out basis, not in excess of market value.

*Property, plant and equipment.* Property, plant and equipment are stated at cost less accumulated depreciation. Additions, improvements and major renewals are capitalized; maintenance, repairs and minor renewals are expensed as incurred. When assets are retired or disposed of, the assets and related accumulated depreciation and amortization are removed from the balance sheet and the resulting gain or loss is reflected in current income. Depreciation is provided using the straight-line method, principally over five to twenty five years for buildings and improvements and two to seven years for machinery and equipment. Depreciation of leasehold improvements is provided using the straight-line method over the life of the asset or the minimum term of the lease, whichever is shorter. Land is not depreciated.

*Software Development Cost.* The Company capitalizes certain internal and external costs incurred to acquire or create internal use software in accordance with AICPA Statement of Position 98-1, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use". Capitalized software is included in property, plant and equipment and is depreciated between two and seven years when development is complete.

## XYRATEX LTD

## NOTES TO AUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(U.S. dollars and amounts in thousands, except per share data, unless otherwise stated)

**2. Basis of Presentation and Summary of Significant Accounting Policies (Continued)**

*Goodwill and purchased intangible assets.* Purchased intangible assets with identifiable lives are carried at cost less accumulated amortization. Amortization is computed using the straight-line method over the estimated economic lives of the respective assets. Under the provisions of Statement of Financial Accounting Standard No. 142, "Goodwill and Other Intangible Assets", goodwill and intangible assets with indefinite lives are not amortized, but instead are tested for impairment at least annually or more frequently if impairment indicators arise.

*Impairment of long-lived assets.* The Company continually monitors events and changes in circumstances that could indicate carrying amounts of long-lived assets, including goodwill, may not be recoverable. When such events or changes in circumstances are present, the Company assesses the recoverability of long-lived assets by determining whether the carrying value of such assets will be recovered through undiscounted expected future cash flows. If the total of the future cash flows is less than the carrying amount of those assets, the Company recognizes an impairment loss based on the excess of the carrying amount over the fair value of the assets.

*Treasury stock.* The Company accounts for its repurchase of shares under the cost method of accounting for treasury stock, whereby the treasury stock is recorded at the cost of reacquisition and reported as a deduction from shareholders equity. Differences in the share price upon subsequent reissuance from the original issuance are recorded through paid in capital. Retirement of treasury shares results in elimination of the original par value, with any excess amounts recorded in retained earnings.

*Derivative financial instruments.* The Company enters into derivative financial instruments (forward foreign currency contracts and foreign currency options) in order to manage currency risks arising from its forecasted and firmly committed foreign currency denominated cash flows. The Company enters into these hedging relationships to limit foreign exchange rate risk for periods not exceeding 24 months. The Company does not utilize financial instruments for trading or speculative purposes. The Company accounts for derivative financial instruments in accordance with Statement of Financial Accounting Standard No. 133, "Accounting for Derivative Instruments and Hedging Activities" ("FAS 133"). As amended, FAS 133 requires that the Company recognize all derivatives as either assets or liabilities in the consolidated balance sheet and measure those instruments at fair value. FAS 133 also prescribes requirements for designation and documentation of hedging relationships and ongoing assessments of effectiveness in order to qualify for hedge accounting. The Company has designated all its forward foreign currency contracts as qualifying for hedge accounting under FAS 133. Changes in fair value of these instruments are deferred and recorded, net of the related tax effects, as a component of accumulated other comprehensive income (AOCI) until the hedged transactions affect earnings, at which time the deferred gains and losses on the forward foreign currency contracts are recognized in the income statement.

*Concentration of credit risk.* Financial instruments which potentially subject the Company to concentrations of credit risk include cash and cash equivalents, short-term investments and accounts receivable. The Company places its cash and cash equivalents and short-term investments with high-credit quality financial institutions. Cash deposits are generally placed with either one or two institutions and such deposits may, at times, exceed governmentally insured limits. Concentrations of credit risk, with respect to accounts receivable, exist to the extent of amounts presented in the financial

XYRATEX LTD

NOTES TO AUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(U.S. dollars and amounts in thousands, except per share data, unless otherwise stated)

**2. Basis of Presentation and Summary of Significant Accounting Policies (Continued)**

statements. Two customers, each with balances greater than 10% of total accounts receivable, represented 61% and 66% of the total accounts receivable balance at November 30, 2007 and 2006, respectively. Generally, the Company does not require collateral or other security to support customer receivables. The Company performs periodic credit evaluations of its customers and maintains an allowance for potential credit losses based on historical experience and other information available to management. Losses to date have been within management's expectations.

Revenues of the Networked Storage Solutions segment include revenue from one customer accounting for 56%, 46% and 48% of the Company's revenues in the years ended November 30, 2007, 2006 and 2005, respectively. Revenues of the Storage Infrastructure segment include revenue from two customers each accounting for 12% of the Company's revenues in the year ended November 30, 2007 and one customer accounting for 28% and 30% of the Company's revenues in the years ended November 30, 2006 and 2005, respectively. No other customer accounted for more than 10% of revenues.

The Company integrates highly specialized components, such as disk drives, printed circuit board assemblies and power supplies into its products. These components are generally available from a single source or a limited number of suppliers. If any of these suppliers failed to meet the Company's timing and quality requirements or unexpectedly discontinued its business relations with the Company, and no alternative supplier were found within a reasonable period of time, the Company's ability to manufacture products at acceptable prices or to deliver products on time could be impaired, possibly resulting in loss of sales.

*Recent accounting pronouncements*

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 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. The Company will adopt FIN 48 in its 2008 fiscal year and is currently evaluating the effect FIN 48 will have on its 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 the Company's 2008 fiscal year. The Company is in the process of assessing the effect FAS 157 may have on its consolidated financial statements.

In February 2007, the FASB issued FAS No. 159 ("FAS 159"), "The Fair Value Option for Financial Assets and Financial Liabilities" including an amendment of FAS No. 115". FAS 159 allows measurement at fair value of eligible financial assets and liabilities that are not otherwise measured at fair value. If the fair value option for an eligible item is elected, unrealized gains and losses for that item shall be reported in current earnings at each subsequent reporting date. FAS 159 also establishes presentation and disclosure requirements designed to draw comparison between the different

## XYRATEX LTD

## NOTES TO AUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(U.S. dollars and amounts in thousands, except per share data, unless otherwise stated)

**2. Basis of Presentation and Summary of Significant Accounting Policies (Continued)**

measurement attributes the company elects for similar types of assets and liabilities. This statement is effective for fiscal years beginning after November 15, 2007. The Company is in the process of evaluating the effect FAS 159 may have on its consolidated financial statements.

In December 2007, the FASB issued FAS No. 141 (Revised 2007), "Business Combinations". FAS 141R retains the fundamental requirements of the original pronouncement requiring that the purchase method be used for all business combinations. FAS 141R defines the acquirer as the entity that obtains control of one or more businesses in the business combination, establishes the acquisition date as the date that the acquirer achieves control and requires the acquirer to recognize the assets acquired, liabilities assumed and any noncontrolling interest at their fair values as of the acquisition date. In addition, FAS 141R requires expensing of acquisition-related and restructure-related costs, remeasurement of earn out provisions at fair value, measurement of equity securities issued for purchase at the date of close of the transaction and non-expensing of in-process research and development related intangibles. FAS 141R is effective for the Company's business combinations for which the acquisition date is on or after December 1, 2009.

**3. Net earnings per share**

Basic net earnings per share is computed by dividing net income by the weighted-average number of common shares. Diluted net earnings per share gives effect to all potentially dilutive common share equivalents outstanding during the period.

	Number of common shares		
	Year Ended November 30,		
	2007	2006	2005
Total weighted average common shares basic	28,985	28,663	28,329
Dilutive effect of share options	724	881	702
Dilutive effect of restricted stock units	177	60	
Total weighted average common shares diluted	29,886	29,604	29,031
Number of options over common shares excluded from the calculation because the effect would be anti-dilutive			10

**4. Other income**

On March 6, 2006, the Company concluded the disposal of a product line through a license agreement of intellectual property of certain network analysis technology and the transfer of the related customer base to Napatech, a programmable network adapter company based in Denmark. The Company is continuing to manufacture the related product lines for Napatech under a separate Supply Agreement. The license agreement required an initial payment of \$2,000 and further payments equal to the amount of annual revenue that was derived from the transferred customers during the twelve months from 1 March 2006 in excess of \$2,000 up to a maximum of \$7,500. Under this agreement payments of \$890 and \$3,167 have been recorded in the statement of operations as other income in the years ended November 30, 2007 and 2006, respectively.

**XYRATEX LTD**

**NOTES TO AUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(U.S. dollars and amounts in thousands, except per share data, unless otherwise stated)**

**5. Acquisition and intangible assets**

*Intangible asset purchases 2007*

During the year ended November 30, 2007, the Company enhanced the intellectual property base within its Networked Storage Solutions segment through the purchase of intellectual property from Ario Data Networks Inc. of Colorado for consideration of \$1,833 including professional fees, and the entry into a patent cross license agreement with IBM for consideration of \$3,000. The Ario transaction also involved the recruitment of certain Ario employees and the purchase of certain non-material tangible assets. Of the amount paid for the Ario intangible assets \$1,536 was amortized in the year ended November 30, 2007. The cost of the cross license has been allocated to intangible assets as patents and core technology to be amortized over five years. These intangible assets are expected to be deductible for tax purposes.

*Acquisition and intangible asset purchase 2006*

During the year ended November 30, 2006, the Company completed an acquisition that was not significant to the operating results and financial position. The cash purchase price for the acquisition was \$1,704. The Company has estimated the fair values of the acquired assets and liabilities and the allocation of the purchase price to intangible assets.

Pro forma operating results have not been presented for the acquisition because the effect of the acquisition was not material. No goodwill has been recognized on the above transaction. \$329 has been allocated to intangible assets as existing customer relationships to be amortized over two years. The intangible assets are expected to be deductible for tax purposes.

During the year ended November 30, 2006, the Company also acquired a portfolio of US patents and related filings in other countries for consideration of \$4,000. This has been allocated to intangible assets as patents and core technology to be amortized over five years. The intangible assets are expected to be deductible for tax purposes.

*nStor Technologies Inc*

On September 8, 2005, the Company completed the acquisition of nStor Technologies, Inc., a company headquartered in Carlsbad, California and listed on the American Stock Exchange. nStor is a developer and provider of data storage subsystems, primarily to OEMs. The purchase price for the shares was cash of \$25,303 including acquisition costs of \$821. The primary purposes of this acquisition were to broaden the range of products and technology base within the Company's Networked Storage Solutions segment.

## XYRATEX LTD

## NOTES TO AUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(U.S. dollars and amounts in thousands, except per share data, unless otherwise stated)

## 5. Acquisition and intangible assets (Continued)

The Company has estimated the fair values of the acquired assets and liabilities. Allocation of the purchase price to tangible and intangible assets is as follows:

Cash	\$ 59
Deferred tax	3,749
Accounts receivable	2,995
Inventory	2,204
Other current assets	193
Property, plant and equipment	425
Accounts payable	(2,383)
Short-term borrowings	(5,111)
Employee compensation and benefits payable	(406)
Deferred revenue	(242)
Other accrued liabilities	(1,610)
	<hr/>
Net tangible liabilities	(127)
Identifiable intangible assets:	
In-Process Research and Development	1,000
Existing technology	3,900
Core technology	1,100
Order backlog	500
Existing customer relationships	1,000
Non-competition agreements	600
Goodwill	17,330
	<hr/>
Initial purchase price	\$ 25,303
	<hr/>

The value attributable to in-process research and development ("IPR&D") was recorded as an operating expense on the acquisition date because the acquired technology had not reached technological feasibility and had no alternative uses. The value was determined by estimating the costs to develop the acquired IPR&D into commercially viable products, estimating the resulting after-tax net cash flows ("free cash flow") from such projects, and discounting the free cash flows back to their present value. The discount rate included a factor that took into account the uncertainty surrounding the successful development of the acquired IPR&D. Goodwill is attributable to the Networked Storage Solutions segment.

Intangible assets with identifiable lives for this acquisition are being amortized on a straight line basis for their remaining lives as follows:

Existing technology	5 years
Core technology	5 years
Order backlog	3 months
Existing customer relationships	5 years
Non-competition agreements	3 years

The intangible assets are expected to be deductible for tax purposes.

## XYRATEX LTD

## NOTES TO AUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(U.S. dollars and amounts in thousands, except per share data, unless otherwise stated)

## 5. Acquisition and intangible assets (Continued)

The results of the acquired business have been included in the Consolidated Statement of Operations with effect from September 8, 2005.

The following unaudited pro-forma summary presents information as if the acquisition of the business and assets of nStor Technologies had occurred as of December 1, 2004. The pro-forma data gives effect to actual operating results prior to the acquisition, adjusted to include certain pro-forma adjustments including the amortization of intangible assets, reduced interest income and a reduced income tax provision. The pro-forma amounts do not purport to be indicative of the results that would have been actually reported if the acquisition had actually occurred at the beginning of the periods presented or that may be reported in the future.

	<b>Unaudited Pro-Forma Year Ended November 30, 2005</b>	
	<hr/>	
Revenue	\$	689,575
Net income from continuing operations	\$	34,257
Net earnings per share from continuing operations:		
Basic	\$	1.21
Diluted	\$	1.18

*Oliver Design*

On May 23, 2005, the Company acquired the business and assets of Oliver Design Inc ("Oliver Design"), based in Scotts Valley, California. The structure of the transaction involved a total cash consideration of \$17,222 including acquisition costs of \$119 with \$3,000 of the acquisition price being deferred for fifteen months. Oliver Design was a privately run business engaged in development and manufacturing of disk drive cleaning technology. The Company's primary reason for the acquisition was to broaden its expertise and product range within its Storage Infrastructure segment.

## XYRATEX LTD

## NOTES TO AUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(U.S. dollars and amounts in thousands, except per share data, unless otherwise stated)

## 5. Acquisition and intangible assets (Continued)

The Company has estimated the fair values of the acquired assets and liabilities. Allocation of the purchase price to tangible and intangible assets is as follows:

Cash	\$ 10,322
Accounts receivable	527
Inventory	10,028
Other current assets	43
Property, plant and equipment	437
Accounts payable	(4,808)
Deferred revenue - customer deposits	(17,072)
Other accrued liabilities	(326)
	<hr/>
Net tangible liabilities	(849)
Identifiable intangible assets:	
Existing technology	4,300
Core technology	2,700
Order backlog	1,200
Existing customer relationships	3,300
Goodwill	6,571
	<hr/>
Initial purchase price	\$ 17,222
	<hr/>

There is no value attributable to In-Process Research and Development. Goodwill is attributable to the Storage Infrastructure segment.

Intangible assets with identifiable lives for this acquisition are being amortized on a straight line basis for their remaining lives as follows:

Existing technology	3 to 7 years
Core technology	7 years
Order backlog	2 years
Existing customer relationships	7 years

The intangible assets are deductible for tax purposes.

The results of the acquired business have been included in the Consolidated Statement of Operations with effect from May 23, 2005.

The following unaudited pro-forma summary presents information as if the acquisition of the business and assets of Oliver Design had occurred as of December 1, 2004. The pro-forma data gives effect to actual operating results prior to the acquisition, adjusted to include certain pro-forma adjustments including the amortization of intangible assets, reduced interest income and an additional income tax provision. The pro-forma amounts do not purport to be indicative of the results that would



## XYRATEX LTD

## NOTES TO AUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(U.S. dollars and amounts in thousands, except per share data, unless otherwise stated)

## 5. Acquisition and intangible assets (Continued)

have been actually reported if the acquisition had actually occurred at the beginning of the periods presented or that may be reported in the future.

	<b>Unaudited Pro-Forma Year Ended November 30, 2005</b>
Revenue	\$ 681,168
Net income from continuing operations	\$ 38,490
Net earnings per share from continuing operations:	
Basic	\$ 1.36
Diluted	\$ 1.33

*Cap Epsilon*

On April 7, 2005 the Company purchased intellectual property for \$2,230 consisting of a software suite which the Company has incorporated into a new product line within its Networked Storage Solutions segment. The purchase price was recorded as In-Process Research and Development expense because the acquired software had not reached technological feasibility and had no alternative uses.

*Identified intangible assets*

Identified intangible assets balances are summarized as follows:

	<b>November 30, 2007</b>		
	<b>Gross Assets</b>	<b>Accumulated Amortization</b>	<b>Net Assets</b>
Existing technology	\$ 11,693	\$ 6,542	\$ 5,156
Patents and core technology	11,887	3,963	7,924
Non-competition agreements	1,000	846	154
Order backlog	2,100	2,100	
Supplier contracts	39	39	
Assembled workforce	1,516	1,493	23
Customer relationships	4,629	1,837	2,787
	<b>\$ 32,864</b>	<b>\$ 16,820</b>	<b>\$ 16,044</b>

## XYRATEX LTD

## NOTES TO AUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(U.S. dollars and amounts in thousands, except per share data, unless otherwise stated)

## 5. Acquisition and intangible assets (Continued)

	November 30, 2006		
	Gross Assets	Accumulated Amortization	Net Assets
Existing technology	\$ 11,300	\$ 4,152	\$ 7,148
Patents and core technology	8,887	1,818	7,069
Non-competition agreements	1,000	615	385
Order backlog	2,100	1,809	291
Supplier contracts	39	29	10
Assembled workforce	124	70	54
Customer relationships	4,629	1,001	3,628
Total	\$ 28,079	\$ 9,494	\$ 18,585

On the basis that no impairment charges are required, the Company expects to record amortization of these intangible assets in its statements of operations as follows:

	Amortization
2008	4,691
2009	4,100
2010	3,686
2011	2,381
2012	1,186

**Goodwill**

The changes in the carrying amount of goodwill for the years ended November 30, 2007 and 2006 are as follows:

	Networked Storage Solutions	Storage Infrastructure	Total
Balance at November 30, 2005	\$ 17,281	\$ 14,253	\$ 31,534
Tax benefit of goodwill		(1,670)	(1,670)
Contingent consideration		9,611	9,611
Adjustment to consideration	49		49
Balance at November 30, 2006	\$ 17,330	\$ 22,194	\$ 39,524
Tax benefit of goodwill		(2,000)	(2,000)
Contingent consideration		607	607
Balance at November 30, 2007	\$ 17,330	\$ 20,801	\$ 38,131

## XYRATEX LTD

## NOTES TO AUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(U.S. dollars and amounts in thousands, except per share data, unless otherwise stated)

## 6. Inventories

	November 30,	
	2007	2006
Finished goods	\$ 19,517	\$ 7,528
Work in progress	18,364	26,275
Raw materials	53,781	59,308
	<u>\$ 91,662</u>	<u>\$ 93,111</u>

## 7. Property, Plant and Equipment, Net

	November 30,	
	2007	2006
Land	\$ 1,421	\$ 1,421
Buildings and leasehold improvements	7,429	6,144
Machinery and equipment	72,616	58,934
	<u>81,466</u>	<u>66,499</u>
Accumulated depreciation	(44,045)	(32,028)
	<u>\$ 37,421</u>	<u>\$ 34,471</u>

Depreciation expense during the years ended November 30, 2007, 2006 and 2005 was \$13,683, \$10,105 and \$6,694, respectively. For the years ended November 30, 2007, 2006 and 2005 the Company disposed of fully-depreciated machinery and equipment with a recorded cost of \$1,219, \$521 and \$1,997, respectively.

## 8. Income Taxes

The provision (benefit) from income taxes from continuing operations is comprised as follows:

		Year Ended November 30,		
		2007	2006	2005
U.K.	Current	\$	\$ (415)	\$ (1,876)
U.S.	Current	538	1,655	1,391
Other jurisdictions	Current	42	(691)	162
	Deferred	(2,305)	5,925	4,287
Total from continuing operations		<u>\$ (1,725)</u>	<u>\$ 6,474</u>	<u>\$ 3,964</u>

Deferred taxes for the years ended November 30, 2007, 2006 and 2005 are stated net of \$2,000, \$1,670 and \$5,368 of tax benefits credited directly to goodwill related to the acquisitions of ZT Automation and nStor Technologies, Inc.

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Deferred taxes for the year ended November 30, 2007 include an income tax expense of \$1,389 resulting from the change in the rate of U.K. income tax enacted during the period.

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## XYRATEX LTD

## NOTES TO AUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(U.S. dollars and amounts in thousands, except per share data, unless otherwise stated)

## 8. Income Taxes (Continued)

The significant components of deferred tax assets and liabilities included in the Consolidated Balance Sheets are:

	November 30,	
	2007	2006
<b>Deferred tax assets:</b>		
U.K. net operating loss carryforwards	\$ 12,351	\$ 753
U.S. net operating loss carryforwards	7,287	19,973
Timing difference on equity compensation	5,324	6,221
Property, plant and equipment	2,972	6,609
Other deferred tax assets		3,000
Less: valuation allowance	(4,347)	(17,271)
	<u>          </u>	<u>          </u>
Total deferred tax assets	\$ 23,587	\$ 19,285
<b>Deferred tax liabilities:</b>		
Forward foreign exchange contracts	(791)	(1,178)
Other deferred tax liabilities	(53)	
	<u>          </u>	<u>          </u>
Net deferred tax assets	\$ 22,743	\$ 18,107

In the United Kingdom, tax operating loss carryforwards have no expiration date. The utilization of tax operating loss carryforwards is, however, restricted to the taxable income of the subsidiary generating the losses. A change in ownership of the Company can also prevent the Company utilizing the carryforwards. As part of the nStor acquisition the Company acquired operating loss carryforwards of nStor Technologies Inc. These are subject to an annual limitation and will expire on various dates beginning in 2018, if not utilized. The Company has recorded a deferred tax asset relating to these loss carryforwards of \$2,940 at November 30, 2007, which is stated net of a valuation allowance of \$4,347. Any release of the valuation allowance against the nStor operating loss carryforwards will be allocated to reduce goodwill arising on the acquisition of nStor. Gross deferred tax assets relating to U.S. operating loss carryforwards of \$12,924 and an equal valuation allowance have been eliminated at November 30, 2007 following the Company's determination that the likelihood of recovery is remote.

The Company adopted FAS 123R, with effect from December 1, 2005, and recorded equity compensation expense using the fair value method during the years ended November 30, 2007 and 2006. This has resulted in the recording of a deferred tax asset of \$3,510 and \$1,826 at the end of these periods. The realization of this asset is dependent on future share price movements over the next four fiscal years as the awards vest. The Company anticipates recording any variation to the value of this asset as an adjustment to Additional Paid in Capital ("APIC"). Under the previous accounting policy using the intrinsic method the Company recorded a separate deferred tax asset relating to share options. At November 30, 2007, \$1,814 of this amount remains. A windfall tax benefit, totaling \$1,476 was added to Additional Paid in Capital in 2005. Following the adoption of FAS 123R described below, windfall tax benefits will only be recognized when they are realized through a benefit to cash flow.

The Company has elected to adopt the short-form method of FASB Staff Position FAS 123R-3 to calculate its pool of windfall tax benefits, as of December 1, 2005. FAS 123R prohibits the recognition of net operating losses generated by windfall tax benefits. The Company has elected to adopt the

## XYRATEX LTD

## NOTES TO AUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(U.S. dollars and amounts in thousands, except per share data, unless otherwise stated)

**8. Income Taxes (Continued)**

"with-and-without" intra-period tax allocation as described in EITF Topic D-32. As a result, windfall tax benefits are recognised in APIC only if an incremental benefit is provided after considering all other tax attributes presently available to the Company. The tax benefits not recognised in APIC for the years ended November 30, 2007 and 2006 as a result of adopting the "with-and-without" approach were \$2,498 and \$568, respectively.

The applicable statutory rate of tax in Bermuda was zero for each of the years ended November 30, 2007, 2006 and 2005. For purposes of reconciliation between the provision for (benefit from) income taxes at the statutory rate and the effective tax rate, a notional U.K. 30% rate is applied as follows:

	Year Ended November 30,		
	2007	2006	2005
Provision (benefit) for income taxes at corporation tax rate	30.0%	30.0%	30.0%
Adjustment in respect of prior years	(17.2)	(4.6)	(5.6)
Nondeductible equity compensation	0.6	0.5	0.7
Other nondeductible expenses	0.6		0.3
Research and development tax credits	(6.5)	(2.4)	(2.6)
Foreign exchange differences	(4.7)		
Effect of change in U.K. tax rate	5.3		
Tax differentials on foreign income	(14.7)	(13.4)	(14.2)
Provision (benefit) for income taxes	(6.6)%	10.1%	8.6%

The components of income (loss) from continuing operations before income taxes are:

	Year Ended November 30,		
	2007	2006	2005
U.K.	\$ 11,574	\$ 29,511	\$ 22,053
U.S.	2,877	2,956	2,700
Malaysia	9,987	31,668	21,100
Other	1,946	517	
Total	\$ 26,384	\$ 64,652	\$ 45,853

As a result of certain employment and capital investment actions undertaken by the Company, income from activities in Malaysia is substantially exempt from income taxes for tax years through May 31, 2012. The income tax benefit attributable to this tax status was estimated to be \$2,996, \$9,300 and \$6,188 during the years ended November 30, 2007, 2006 and 2005, respectively.

**9. Equity compensation plans**

As described in Note 2, with effect from December 1, 2005, the Company adopted FAS 123R, which establishes accounting for share-based awards exchanged for employee services, using the modified prospective application transition method. Accordingly, equity compensation cost is measured at grant date, based on the fair value of the award, over the requisite service period.



## XYRATEX LTD

## NOTES TO AUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(U.S. dollars and amounts in thousands, except per share data, unless otherwise stated)

## 9. Equity compensation plans (Continued)

Previously, the Company applied APB 25 and related Interpretations, as permitted by FAS 123. Under this policy, the Company recorded non cash equity compensation expense of \$828 for the year ended November 30, 2005.

The Company and Credit Suisse, the managing underwriter for the Company's Initial Public Offering (IPO) in 2004, have agreed to impose a limit on the number of common shares over which options may be granted, to the effect that the total number of common shares over which options may be granted under all of the Company's share option, share purchase, restricted stock, restricted stock units and stock bonus award plans shall not, in any consecutive ten year period, commencing after the IPO, exceed 5,633. Lapsed and surrendered options are disregarded for these purposes. At November 30, 2007, share awards over 2,526 common shares had been granted since the IPO. Where the number of share awards which can be granted under a specific plan is subject to a limit then these limits are stated below.

*Restricted Stock Units*

RSUs require that shares be awarded over four years from the date of grant, subject to continued service. The vesting of certain of these units is also subject to the achievement of certain performance conditions in the year of grant. The RSUs vest annually on February 1. An employee ceases to be entitled to the RSUs upon termination of their employment. Equity compensation expense related to RSUs of \$6,121 and \$3,405 has been recorded in the years ended November 30, 2007 and 2006 respectively. The calculation of the number of units expected to vest is based on management's assessment of achievement of the related performance conditions.

Restricted stock units granted, exercised, canceled and expired are summarized as follows:

	RSU	Weighted-Average Grant Date Fair Value	Weighted-Average Remaining Contractual Term (years)	Aggregate Intrinsic Value
Granted	540	25.24		
Vested				
Cancelled/forfeited	(29)	26.31		
	<u>511</u>			
Non-vested restricted stock units at November 30, 2006	511	25.18	3.3	
Granted	483	22.91		
Vested	(93)	25.65		
Cancelled/forfeited	(116)	25.24		
	<u>785</u>			
Non-vested restricted stock units at November 30, 2007	785	23.74	3.2	
	<u>602</u>			
Non-vested restricted stock units expected to vest at November 30, 2007	602		3.1	\$ 8,879

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**XYRATEX LTD**

**NOTES TO AUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(U.S. dollars and amounts in thousands, except per share data, unless otherwise stated)**

**9. Equity compensation plans (Continued)**

*Share Option Plans*

The Company has five plans under which employees have been granted options to purchase Xyratex Ltd common shares.

*Xyratex Ltd Approved Plan*

Options granted under this plan may have certain tax advantages for employees and vest at the earlier of a takeover or liquidation of the Company, or ratably, over a period of four years from the grant date. Options granted under the plan expire at the earlier of ten years from the date of grant, six months after a change of control, amalgamation or liquidation of the Company or immediately upon termination of employment with the Company. As of November 30, 2007, options to purchase 681 common shares were outstanding under the plan.

*2004 Plan*

Options granted under this plan vest over periods ranging from three to four years from the grant date, or earlier upon a change of control of the Company. Options granted under the plan expire at the earlier of ten years from the date of grant, 15 days after a change of control if the acquiring entity does not exchange or carry over the outstanding options, or 30 days from termination of employment with the Company. The maximum number of shares that can be issued under this plan is 5,000. As of November 30, 2007, options to purchase 812 common shares were outstanding under the plan.

*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 Xyratex Ltd common shares to certain directors. The options vested at 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 or more than ten years after the date of grant. The maximum number of shares that can be issued under this plan is 60. As of November 30, 2007, options to purchase 40 common shares were outstanding under the plan.

*Chairman's Stock Option Plan*

Options under this plan vested at 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 or more than ten years after the date of grant. The maximum number of shares the Company can issue under the plan is 228. As of November 30, 2007, options to purchase 228 common shares were outstanding under the plan.

*The Sharesave Plan*

The Sharesave Plan was established in 2005. Options granted under this plan have certain tax advantages for employees. Options can only be exercised at the end of a three year period based on the amount paid by an employee into an independent savings account. The options have been granted with an exercise price at a discount of 15% to the market price and the maximum monthly contribution to this plan, stated in U.K. pounds, is £250 determined at the commencement of the three year period.

## XYRATEX LTD

## NOTES TO AUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(U.S. dollars and amounts in thousands, except per share data, unless otherwise stated)

## 9. Equity compensation plans (Continued)

Sharesave Plan activity was as follows:

Grant date	March 2007	March 2006	March 2005
Exercise price	\$ 19.71	\$ 22.95	\$ 14.46
Options to purchase common shares outstanding at November 30, 2005			159
Granted		20	
Options to purchase common shares outstanding at November 30, 2006		20	159
Granted	21		
Cancelled/forfeited		(7)	(7)
Options to purchase common shares outstanding at November 30, 2007	21	13	152
Aggregate intrinsic value	\$	\$	\$ 43

*Share Option Activity*

Options granted, exercised, canceled and expired under all of the Company's share option plans, excluding the Sharesave Plan, are summarized as follows:

	Options	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term (years)	Aggregate Intrinsic Value
Outstanding at November 30, 2004	3,920	\$ 4.42		
Granted	1,353	14.23		
Exercised	(1,758)	3.12		
Cancelled/forfeited	(38)	12.77		
Outstanding at November 30, 2005	3,477	\$ 8.82		
Exercised	(990)	4.83		
Cancelled/forfeited	(150)	12.67		
Outstanding at November 30, 2006	2,337	\$ 10.26		
Exercised	(350)	7.86		
Cancelled/forfeited	(226)	13.54		
Outstanding at November 30, 2007	1,761	\$ 10.41	5.8	\$ 7,625
Exercisable at November 30, 2005	1,936	\$ 3.61		
Exercisable at November 30, 2006	1,428	\$ 7.84		
Exercisable at November 30, 2007	1,448	\$ 9.59	5.5	\$ 7,460

<b>Options</b>	<b>Weighted-Average Exercise Price</b>	<b>Weighted-Average Remaining Contractual Term (years)</b>	<b>Aggregate Intrinsic Value</b>
<hr/>	<hr/>	<hr/>	<hr/>
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## XYRATEX LTD

## NOTES TO AUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(U.S. dollars and amounts in thousands, except per share data, unless otherwise stated)

## 9. Equity compensation plans (Continued)

Exercise prices of option activity during each year denominated in U.K. pounds have been converted to the U.S. dollar equivalent in the above table using the U.K. pound/U.S. dollar exchange rate as of each transaction date. Exercise prices of options outstanding at dates reported in the table above and denominated in U.K. pounds have been converted to the U.S. dollar equivalent using the U.K. pound/U.S. dollar exchange rate ruling as of that date.

The aggregate intrinsic value of options outstanding at November 30, 2007 is calculated as the difference between the market price of the underlying common share and the exercise price of the options. Of the outstanding options at November 30, 2007, 45,000 had exercise prices that were higher than the \$14.74 closing market price of the Company's common shares on that date. The weighted-average fair value of options granted in the years ended November 30, 2005 was \$8.61. The total intrinsic value of options exercised during the years ended November 30, 2007, 2006 and 2005 was \$4,835, \$17,452 and \$23,135, respectively, determined as of the date of exercise. The total fair value of options that vested during the years ended November 30, 2007 and 2006 was \$237 and \$3,191, respectively. The total fair value of options that were forfeited during the years ended November 30, 2007 and 2006 was \$799 and \$658, respectively.

The following table summarizes information about share options outstanding at November 30, 2007:

Exercise Prices	Options Outstanding			Options Exercisable		
	Number Outstanding	Weighted-Average Remaining Contractual Life (in years)	Weighted-Average Exercise Price	Number Exercisable	Weighted-Average Exercise Price	
\$2.83 - \$2.84	391	3.5	\$ 2.98	391	\$ 2.98	
\$5.19 - \$5.20	264	4.6	\$ 5.47	264	\$ 5.47	
\$9.65 - \$10.25	22	6.6	\$ 9.98	22	\$ 9.98	
\$13.51 - \$14.47	1,039	6.9	\$ 14.24	748	\$ 14.29	
\$15.57 - \$17.40	45	7.5	\$ 15.80	23	\$ 15.80	
	1,761	5.8	\$ 10.41	1,448	\$ 9.59	

*Employee Stock Purchase plan*

The Company also operates an employee stock purchase plan (the "ESPP"), under which any eligible U.S. employee of the Company receives the rights to purchase the Company's shares. A purchase right entitles a participant to purchase at the end of each offering period, subsequent to the IPO each fiscal quarter, the number of 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 is 85% of the lower of the fair market value of one common share 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. The payroll deductions may not exceed two hundred dollars per pay period per employee, and an employee may not purchase more than \$25 of fair value of shares in any annual period. The ESPP terminates in December 2021.

XYRATEX LTD

NOTES TO AUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(U.S. dollars and amounts in thousands, except per share data, unless otherwise stated)

**9. Equity compensation plans (Continued)**

There were 31, 34 and 29 shares awarded under this plan in the years ended November 30, 2007, 2006 and 2005, respectively.

***Restricted Shares***

Restricted share awards are awards of the Company's 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 are subject to the Company's right of repurchase or forfeiture.

At November 30, 2007 no restricted shares were outstanding. 195 restricted shares were awarded in 2005. No expense has been recorded in connection with these awards because the Company did not consider it probable that the related performance criteria would be met and the awards were subsequently forfeited.

In addition, included in issued common shares are 280 shares which were purchased by certain directors and management in February 2004 and which were subject to repurchase by the Company at their purchase price. The repurchase restrictions lapsed and therefore the shares became vested over a four year period, with the first tranche vesting on November 30, 2004. As of November 30, 2007 all of these shares had vested. At November 30, 2006, 65 shares remained unvested. Included in equity compensation expense in the year ended November 30, 2007 is \$51 relating to the vesting of these shares. The fair value of the shares which vested during the years ended November 30, 2007, 2006 and 2005 was \$958, \$1,485 and \$1,060, respectively.

***Determining Fair Value of Share Options Under FAS 123R***

*Valuation and Amortization Method.* The Company estimated the fair value of share options using the Black-Scholes option valuation model and amortized the fair value using graded vesting over the vesting periods.

*Expected Life.* The expected life of awards granted represents the period of time that they are expected to be outstanding. The Company determined the expected life based on historical experience with similar awards, giving consideration to the contractual terms, vesting schedules and pre-vesting and post-vesting forfeitures. Share options granted during the year ended November 30, 2005 vest 25% per year over four years and have contractual terms of ten years. Share purchases under the share purchase plan have an expected life of three months, which is equal to the offering period.

*Expected Volatility.* The volatility factor the Company used in the Black-Scholes option valuation model was based on the Company's historical share prices since its Initial Public Offering in 2004 and the reported historical volatility of comparable companies.

*Risk-Free Interest Rate.* The Company based the risk-free interest rate used in the Black-Scholes option valuation model on the implied yield currently available on U.S. Treasury zero-coupon issues with an equivalent remaining term equal to the expected life of the award.

## XYRATEX LTD

## NOTES TO AUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(U.S. dollars and amounts in thousands, except per share data, unless otherwise stated)

## 9. Equity compensation plans (Continued)

*Expected Dividend Yield.* The Company has never paid any cash dividends on its common shares and the Company does not anticipate paying any cash dividends in the foreseeable future. Consequently, the Company used an expected dividend yield of zero in the Black-Scholes option valuation model.

*Expected Forfeitures.* The Company uses historical data to estimate pre-vesting option forfeitures. The Company records share-based compensation only for those awards that are expected to vest.

The fair value of the options was estimated at grant date using the following weighted average assumptions:

	Year Ended November 30	
	2006	2005
Risk-free interest rate	4.75%	3.75%
Dividend yield	0.00%	0.00%
Volatility	75%	80%
Expected option life	1.5 years	4 years

**Equity Compensation Under FAS 123R**

The following table summarizes equity compensation expense related to share-based awards under FAS 123R for the year ended November 30, 2007.

	Year ended November 30,	
	2007	2006
Equity compensation:		
Cost of revenues	\$ 1,238	\$ 923
Research and development	2,477	1,962
Selling, general and administrative	4,342	4,309
<b>Total equity compensation</b>	<b>8,057</b>	<b>7,194</b>
Related income tax benefit	\$ 2,126	\$ 1,826

At November 30, 2007 the Company had 1,264 non-vested share based awards that had a weighted average grant date fair value of \$17.52. As of November 30, 2007, the Company had \$8,709 of total unrecognized compensation cost related to non-vested share-based awards granted under all equity compensation plans. Total unrecognized compensation cost will be adjusted for any future changes in estimated forfeitures. The Company expects to recognize this cost over a weighted average period of 2.7 years.

**Pro Forma Information Under FAS 123 and APB 25**

Prior to the Company's 2006 fiscal year, share-based compensation plans were accounted for using the intrinsic value method prescribed in APB 25 and related Interpretations. Equity compensation of

## XYRATEX LTD

## NOTES TO AUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(U.S. dollars and amounts in thousands, except per share data, unless otherwise stated)

## 9. Equity compensation plans (Continued)

\$828 was recorded in net income in the year ended November 30, 2005. No equity compensation was recorded where share options granted had an exercise price equal to or greater than the market value of the underlying common shares on the date of grant. Had compensation cost for the plans been determined based on the fair value at the grant dates for awards under those plans consistent with the method of FAS 123, the Company's net income and basic and diluted net income per share would have been changed to the pro forma amounts indicated below (in thousands, except for per share data):

	<b>Year Ended November 30, 2005</b>
Net income as reported	\$ 42,169
Add: equity compensation included in net income, net of related tax effects	828
Deduct: equity compensation determined under fair value based method for all awards, net of related tax effects	(4,981)
Pro forma net income	\$ 38,016
<b>Earnings per share</b>	
Basic as reported	\$ 1.49
Diluted as reported	\$ 1.45
Basic pro forma	\$ 1.34
Diluted pro forma	\$ 1.31

## 10. Equity Share Capital

The Company's authorized share capital consists of three classes; 70,000 common shares; 1,000 preference shares; and, 1,200 deferred shares. All shares have a par value of \$0.01. As of November 30, 2007 there were 29,117 common shares outstanding. No other class of shares has been issued.

*Common shares* Holders of common shares are entitled to one vote per share on all matters upon which the common shares are entitled to vote, including the election of directors. The holders of common shares are entitled to receive dividends when and as declared by the Company's board of directors. Upon any liquidation, dissolution, or winding up of the Company, surplus assets will be distributed ratably to holders of common shares. There are no restrictions on these shares.

*Preference shares* The Board is authorized to provide for the issuance of the preference shares in one or more series, and to establish from time to time the number of shares to be included in each such series, and to fix the designation, powers, preferences and rights of the shares of each such series and the qualifications, limitations or restrictions thereof (and, for the avoidance of doubt, such matters and the issuance of such preference shares shall not be deemed to vary the rights attached to the common shares). As of November 30, 2007, there were no preference shares outstanding.

*Deferred shares* While ever and whenever any shares of the Company of any other class are in issue: (a) Holders of deferred shares shall have no right to receive notice of general meetings nor shall deferred shares entitle the holder to any votes at general meetings of the Company; (b) deferred shares shall have no right to participate in any dividend or distribution and, on a return of capital shall entitle

**XYRATEX LTD**

**NOTES TO AUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(U.S. dollars and amounts in thousands, except per share data, unless otherwise stated)**

**10. Equity Share Capital (Continued)**

the holder to no rights other than to repayment of the par value thereof and then only once \$1,000,000 per share has been paid to holders of all other classes of shares of the Company then in issue. As of November 30, 2007, there were no deferred shares outstanding.

**11. Employee benefit trusts**

The Company has a variable interest in an employee benefit trust (the "Trust") which was formed in 1994 by Havant International Holdings Limited (HIHL), a predecessor holding company, for the benefit of current and former employees and to facilitate obligations under HIHL's share option plans. Following the demerger of the Company's business from HIHL in 2000, the Trust holds shares of the Company. Assets held by the Trust are used to compensate current employees of the Company and former employees of HIHL and its subsidiaries. The Company is not the primary beneficiary of the Trust because it does not absorb expected losses of the Trust, nor does it receive expected residual returns of the Trust. As of November 30, 2007 and 2006, the Trust held 298 and 444 common shares, respectively. The Trust has not made any new awards since 2004.

Transactions between the Trust and employees of the Company, such as the granting of shares, options over shares, or cash bonuses paid to employees, have been accounted for in accordance with APB 25 before November 30, 2005 and FAS 123R thereafter, and any resulting compensation expense has been pushed down into these financial statements with an offsetting entry to additional paid in capital. Activity related to equity based compensation awards given to employees are included in the share option and award activity in Note 9.

The Trust pays administrative fees to the Company of \$9 per year and paid part of a company bonus of \$144 in the year ended November 30, 2005.

The Company set up a new employee benefit trust in June 2004. This trust holds 112 common shares in Xyratex Ltd, included in unissued shares at November 30, 2007. Shares held by this trust will be used to satisfy the exercise by employees of certain share options of the Company granted during the year ended November 30, 2005.

**12. Short-term Borrowings and Long-term Debt**

As of November 30, 2007, the Company has credit facilities with a major U.K. financial institution (the "Bank") under which it has a revolving line of credit which expires in December 2008 of up to \$30,000 and an overdraft facility of up to \$15,000. No amounts are outstanding under these facilities at November 30, 2007. Any amounts borrowed under the revolving line of credit facility would be repayable in 2008. Any amounts borrowed under the overdraft facility would be repayable on demand.

Interest is payable at between 0.6% and 1.25% above LIBOR on the revolving credit facility, depending on the level of debt relative to operating income. Interest is payable at 0.75% above LIBOR on the overdraft facility and the term loan. Amounts under the revolving credit and overdraft facilities may be borrowed in U.K. pounds or U.S. dollars and separate currency LIBOR rates apply for each currency. The revolving credit facility contains restrictive covenants that, among other provisions, require compliance with certain financial covenants including levels of income from operations relative to net interest and tangible net assets as determined in accordance with accounting principles generally accepted in the U.S. The facilities are collateralized by substantially all of the assets of the Company.



## XYRATEX LTD

## NOTES TO AUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(U.S. dollars and amounts in thousands, except per share data, unless otherwise stated)

**13. Financial Instruments**

The Company's principal financial instruments, other than derivatives, comprise short-term borrowings, cash and cash equivalents, accounts receivable, accounts payable and accrued liabilities. The Company also enters into derivatives in order to manage currency risks arising from the Company's operations. The Company does not hold financial instruments for trading purposes.

*Forward foreign exchange contracts and options*

Over 90% of the Company's revenues are denominated in the U.S. dollar, whereas certain expenses are incurred in U.K. pounds and Malaysian Ringgits. Therefore, the Company is exposed to foreign currency exchange rate risk which creates volatility in income and cash flows from period to period. In part, the Company manages this exposure through entering into forward foreign exchange contracts and options to reduce the volatility of income and cash flows associated with this risk.

The Company formally documents all relationships between hedging instruments and hedged items, as well as its risk-management objectives and strategies for undertaking various hedge transactions. The Company links all derivatives that are designated as hedging instruments in foreign currency cash flow hedges to forecasted transactions or firm commitments. In accordance with the provision of FAS 133, the Company assesses, both at the inception of each hedge and on an on-going basis, whether the derivatives that are designated in hedge qualifying relationships are highly effective in offsetting changes in the cash flows of hedged items. If it is determined that a derivative is no longer highly effective as a hedge, the Company discontinues hedge accounting prospectively. The counterparty to the foreign currency contracts is an international bank. Such contracts are for two years or less.

The Company reclassified a gain of \$2,774 net of tax of \$1,189 from AOCI to earnings during the year ended November 30, 2007 due to the realization of the underlying transactions. Such amounts were recorded as selling, general and administrative expense. The Company recorded the change in fair market value of derivatives related to its cash flow hedges, the balances of which are recorded in other current assets, to AOCI of \$1,847, net of tax of \$791 for the year ended November 30, 2007. For the year ended November 30, 2006 the Company recorded in other current assets, movements to AOCI of \$2,774, net of tax of \$1,189. Any remaining unrealized amounts are expected to be reclassified to earnings during the next twelve months. The fair value of these foreign currency contracts represents the amount the Company would receive or pay to terminate the contracts, considering first, quoted market prices of comparable agreements, or in the absence of quoted market prices, such factors as interest rates, currency exchange rates and remaining maturity.

The following table shows derivatives existing as of November 30, 2007 and November 30, 2006:

Derivatives between U.K. pound and U.S. dollar	November 30,	
	2007	2006
Forward exchange contracts and options	\$ 63,344	\$ 43,294
Fair value of contracts asset	\$ 2,440	\$ 3,762
Carrying value of contracts asset	\$ 2,440	\$ 3,762
Average rate of contract	\$ 1.98	\$ 1.80
Period end rate	\$ 2.06	\$ 1.95
Maximum period of contracts (months)	12	12

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## XYRATEX LTD

## NOTES TO AUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(U.S. dollars and amounts in thousands, except per share data, unless otherwise stated)

## 13. Financial Instruments (Continued)

Derivatives between Malaysian ringgit and U.S. dollar	November 30,	
	2007	2006
Forward exchange contracts and options	\$ 5,000	\$ 6,500
Fair value of contracts asset	\$ 196	\$ 46
Carrying value of contracts asset	\$ 196	\$ 46
Average rate of contract	\$ 0.29	\$ 0.28
Period end rate	\$ 0.29	\$ 0.28
Maximum period of contracts (months)	6	12

*Fair values*

The carrying values of all financial instruments, including forward foreign exchange contracts, approximate their fair values.

## 14. Commitments and Contingencies

*Operating Lease Commitments:* The Company leases certain real and personal property from both unrelated third parties and a former related party (see Note 17). Future minimum lease payments under non-cancelable operating lease agreements as of November 30, 2007 are as follows:

	Related party	Other	Total
Year Ending November 30:			
2008	\$ 5,076	\$ 2,342	\$ 7,418
2009	4,765	2,114	6,879
2010	1,765	1,605	3,370
2011	500	842	1,342
2012	500	468	968
2013 and thereafter	500	265	765
Total minimum payments required	\$ 13,106	\$ 7,636	\$ 20,742

Certain leases require the Company to pay property taxes, insurance and routine maintenance. Rent expense was \$7,199, \$6,342 and \$5,592 for the years ended November 30, 2007, 2006 and 2005, respectively.

These expenses include \$4,584, \$3,732 and \$3,319 for the years ended November 30, 2007, 2006 and 2005, respectively to a former related party (Note 17).

*Customer Indemnity.* As an element of standard customer contracts, the Company includes certain clauses that indemnify the customer against liability and damages, including legal defense costs, which might arise from claims of patent, copyright, trademark or trade secret infringement by the products manufactured by the Company.

*Contingencies.* The Company is involved in lawsuits, claims, investigations and proceedings, including patent and commercial matters that arise in the ordinary course of business. There are no

## XYRATEX LTD

## NOTES TO AUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(U.S. dollars and amounts in thousands, except per share data, unless otherwise stated)

## 14. Commitments and Contingencies (Continued)

such matters pending that the Company expects to be material in relation to its business, consolidated financial position, results of operations or cash flows.

*Product warranty.* The following table provides the changes in the product warranty accrual for the year ended November 30, 2007:

	<u>Amount of liability</u>
Balance at November 30, 2004:	\$ 1,919
Acquisition of businesses	303
Accruals for warranties issued during the year	2,046
Settlements made during the year	(1,723)
	<u>2,545</u>
Balance at November 30, 2005:	\$ 2,545
Accruals for warranties issued during the year	3,280
Settlements made during the year	(2,669)
	<u>3,156</u>
Balance at November 30, 2006:	\$ 3,156
Accruals for warranties issued during the year	3,099
Settlements made during the year	(2,712)
	<u>3,543</u>
Balance at November 30, 2007:	<u>\$ 3,543</u>

## 15. Supplemental Cash Flow Information

Cash paid for income taxes was \$816 and cash received was \$359 for the year ended November 30, 2007. Cash paid for income taxes was \$1,004 and cash received was \$541 for the year ended November 30, 2006. Cash paid for income taxes was \$1,733 and cash received was \$1,407 for the year ended November 30, 2005. Cash paid for interest was \$295, \$716 and \$450 for the years ended November 30, 2007, 2006 and 2005, respectively.

Proceeds from the exercise of share options were \$2,905, \$3,610 and \$2,175 for the years ended November 30, 2007, 2006 and 2005 respectively.

Non cash investing and financing activities included the recording of an acquisition note payable of \$3,000 in connection with the acquisition of Oliver Design during 2005.

## 16. Segment Information

*Description of segments.* The Company designs, develops and manufactures enabling technology in support of high-performance storage and data communication networks. The Company organizes its business operations into two product groups Networked Storage Solutions and Storage Infrastructure, each of which comprises a reportable segment.

Description of the Company's segments:

*Networked Storage Solutions.* Provision of high performance, high density, network storage subsystem technology to OEMs supplying the network storage and data networking market places.



## XYRATEX LTD

## NOTES TO AUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(U.S. dollars and amounts in thousands, except per share data, unless otherwise stated)

## 16. Segment Information (Continued)

*Storage Infrastructure.* Provision of high-performance, high density disk drive, process & test technology to the major disk drive companies and their component suppliers for the development and production of highly reliable disk drives.

*Segment revenue and profit.*

The accounting policies used to derive reportable segment results are generally the same as those described in Note 2, "Summary of Significant Accounting Policies".

The following tables reflect the results of the Company's reportable segments under the Company's management reporting system. These results are not necessarily a depiction that is in conformity with accounting principles generally accepted in the United States and in particular does not include the non-cash equity compensation charge. The performance of each segment is generally measured based on gross profit before non-cash equity compensation.

	Year Ended November 30,		
	2007	2006	2005
<b>Revenues:</b>			
Networked Storage Solutions	\$ 693,990	\$ 598,752	\$ 415,379
Storage Infrastructure	237,643	384,881	264,230
Total Segments	\$ 931,633	\$ 983,633	\$ 679,609
<b>Gross profit:</b>			
Networked Storage Solutions	\$ 100,573	\$ 82,762	\$ 64,831
Storage Infrastructure	69,716	115,447	79,463
Total Segments	170,289	198,209	144,294
Non cash equity compensation	(1,238)	(923)	
Total	\$ 169,051	\$ 197,286	\$ 144,294
<b>Depreciation and amortization:</b>			
Networked Storage Solutions	\$ 12,238	\$ 7,864	\$ 4,874
Storage Infrastructure	6,981	6,390	4,618
Total Segments	19,219	14,254	9,492
Corporate	1,768	974	420
Total	\$ 20,987	\$ 15,228	\$ 9,912

Total segments revenue represents total revenues as reported by the Company for all periods presented. Gross profit above represents gross profit as reported by the Company for all periods presented. Income from continuing operations before income taxes as reported by the Company for all periods presented also includes total operating expenses, other income and net interest income. The chief operating decision maker does not review asset information by segment and therefore no asset information is presented.

## XYRATEX LTD

## NOTES TO AUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(U.S. dollars and amounts in thousands, except per share data, unless otherwise stated)

## 16. Segment Information (Continued)

## Geographic Information

	United States	United Kingdom	Malaysia	Other	Total
Revenues (based on location at which the sale originated):					
Year Ended November 30, 2007	\$ 562,869	\$ 167,698	\$ 197,790	\$ 3,276	\$ 931,633
Year Ended November 30, 2006	\$ 563,183	\$ 126,528	\$ 292,748	\$ 1,174	\$ 983,633
Year Ended November 30, 2005	\$ 373,621	\$ 104,479	\$ 201,509	\$	\$ 679,609
Long-lived assets (all non-current assets):					
November 30, 2007	\$ 8,952	\$ 70,753	\$ 11,454	\$ 437	\$ 91,596
November 30, 2006	\$ 9,110	\$ 73,432	\$ 9,606	\$ 432	\$ 92,580
November 30, 2005	\$ 6,107	\$ 62,055	\$ 8,056	\$ 329	\$ 76,547

## 17. Related parties

The Company sold its U.K. property in 2000 as part of demerger of a predecessor holding company. As part of the demerger the terms of leases of this property, were agreed. The Company continues to occupy this property and although the landlord of this property is not a related party at November 30, 2007 the terms of the leases were agreed before the demerger or when the landlord and the Company had substantially common ownership. The amounts paid for rent and related services was \$4,584, \$3,732 and \$3,319 for the years ended November 30, 2007, 2006 and 2005, respectively.

## 18. Subsequent events

On January 14, 2008 the Company commenced a share buy-back program. The Company has announced that it will purchase its own shares up to a value of \$30 million and it is anticipated that the repurchase will take place over a period of up to one year. At January 31, 2007 the Company has purchased 169,000 shares at a total value of \$2,612.