XYRATEX LTD
Form 20-F
February 20, 2007

XYRATEX LTD

ANNUAL REPORT FOR THE YEAR ENDED

NOVEMBER 30, 2006

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

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 20-F

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

or

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

For the Fiscal Year Ended November 30, 2006

or

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

or

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

(Commission file number 000-50799)

XYRATEX LTD

(Exact Name of Registrant as Specified in Its Charter)

Bermuda

(Jurisdiction of Incorporation or Organization)

Langstone Road

Havant PO9 1SA

United Kingdom

(011) 44 2392 496000

(Address of Principal Executive Offices)

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

None

(Title of class)

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

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

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

None

(Title of class)

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

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

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

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

Yes o No x

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

Yes o No x

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

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

Yes x No o

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

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

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

Item 17 o Item 18 x

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

Yes o No x

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INTRODUCTION

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

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

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

INDUSTRY DATA

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

CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

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

PART I

ITEM 1: IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISERS

Not applicable.

ITEM 2: OFFER STATISTICS AND EXPECTED TIMETABLE

Not applicable.

ITEM 3: KEY INFORMATION

Item 3A: Selected Financial Data

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

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

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

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

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

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

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

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

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

Item 3B: Capitalization and Indebtedness

Not applicable.

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

Not applicable.

Item 3D: Risk Factors

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Our manufacturing process depends on the availability and timely supply of components which meet our specifications and quality demands. Some of the components that we integrate into our own products are highly specialized and may only be available from a single source or a limited number of suppliers. In particular, we depend on Solectron Corporation as our sole source supplier for the provision of electronic circuit boards. Our reliance on Solectron reduces our control over the manufacturing process, exposing us to risks including reduced control over quality assurance, increased production costs and reduced product supply. If we fail to manage effectively our relationship with Solectron, or if Solectron experiences delays, disruptions, capacity constraints or quality control problems in their manufacturing operations, our ability to ship products to our customers could be impaired and our competitive position and reputation could be damaged. Moreover, if any of our suppliers were to cancel or materially change their commitments to us or fail to meet the quality or delivery requirements needed to satisfy customer demand for our products, we could lose time-sensitive orders, be unable to develop or sell some products cost-effectively or on a timely basis, if at all, and have significantly decreased revenues, margins and earnings, which would have a material adverse effect on our business. In addition, our suppliers may go out of business, be impacted by natural disasters or may cease production of components, and it can take a substantial period of time to qualify a new supplier of components. Moreover, we obtain these components through purchase order arrangements and do not have long-term supply agreements in place with our suppliers.

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

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

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

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

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

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

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

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

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

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

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

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

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

We have a long and unpredictable sales cycle.

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

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

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

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

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

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

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

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

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

- potential tariffs and other trade barriers;

- unexpected changes in regulatory requirements;

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

- *Business combinations with interested shareholders*: United States companies in general may not enter into business combinations with interested shareholders, namely certain large shareholders and affiliates, unless the business combination has been approved by the board of directors in advance or by a supermajority of shareholders or the business combination meets specified conditions. Under Bermuda law, and under our bye-laws, our board of directors may approve certain business combinations with interested shareholders without the need for a shareholder vote although certain business combinations, such as amalgamations, an arrangement under Bermuda law whereby two corporate entities combine and continue as a combined corporate entity but where neither of the original corporate entities cease to exist, usually require shareholder approval.

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

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

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

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

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

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

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

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

ITEM 4: INFORMATION ON THE COMPANY

Item 4a: History and Development

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

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

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

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

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

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

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

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

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

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

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

Item 4b: Business Overview

Business Overview

We are a leading provider of modular enterprise-class data storage solutions and storage process technology. We design, develop and manufacture enabling technology that provides our customers with data storage products to support high-performance storage and data communication networks. We operate in two business segments: Storage and Network Systems and Storage Infrastructure (SI). In January 2007, the Storage and Network Systems segment changed its name to Networked Storage Solutions or NSS. We believe this change better aligns with our customers needs, the changing market towards networked environments and the market s view of our role as a technology solution provider. Our Networked Storage Solutions products provide modular, highly scalable, high-speed, high-density, reliable and flexible data storage. Our storage subsystems support a range of high-speed communication technologies and cost and performance specifications. Our modular subsystem architecture allows us to support many segments within the networked storage market by enabling different specifications of storage subsystem designs to be created from a standard set of interlocking technology modules. Using data published by International Data Corporation, or IDC, an independent research company, on the number of terabytes shipped in 2005 and forecast for 2006, we estimate that we are responsible for approximately 14% of the world wide external storage systems petabyte shipments through our OEM customer base. This represents 399.4 petabytes in 2006, or over a petabyte shipment every day. A terabyte and a petabyte are units of measurement equal to one thousand gigabytes and one million gigabytes of information, respectively. Our Storage Infrastructure products include disk drive production test systems, process automation, servo track writers and disk cleaning systems. We believe that over 55% of all 3.5 inch disk drives shipped and over 20% of all 2.5 inch disk drives shipped worldwide are processed utilizing either our servo track writer or final test and qualification systems and we estimate that our Storage Infrastructure revenues account for approximately 15% of the capital spend within the annual capital budget of the disk drive industry. We have increased our revenues from $333.7 million in our 2003 fiscal year to $983.6 million in our 2006 fiscal year.

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

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

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

Industry Overview

The last decade has seen a dramatic increase in the volume of data that is being captured, processed, stored and manipulated as digital information. This information is generated from many sources, including critical business applications, e-mail communications, the Internet and multimedia applications, which have collectively fueled an increase in demand for data storage capacity. Additionally, regulatory requirements and company policies requiring data preservation are expanding the use of storage resources in the enterprise. Businesses are now increasingly focusing on the issues surrounding increasing power consumption and thermal management within the enterprise to maintain compliance with emerging environmental legislation and reduce energy costs. We also continue to see a trend towards vendor consolidation and a growing emphasis on data security. This increased storage requirement and data management complexity lead us to believe that a growing opportunity for outsourced data service offerings is emerging within the data storage and IT marketplace. According to IDC, in a report issued in May of 2006, worldwide IT storage revenues will continue to experience significant revenue growth. They projected revenues from all storage hardware, software and services, within the information technology or IT sector, to grow from $71 billion in 2006 to $82 billion in 2009. Terabytes shipments of all types of Enterprise Storage were also expected to increase at a compound annual growth rate of 56% until 2009.

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

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

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

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

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

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

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

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

Networked Storage Solutions Market

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

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

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

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

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

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

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

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

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

Storage Infrastructure Market

Hard disk drive sales in 2005, in terms of unit shipments, grew at a rate of 24.9%, to over 381 million, according to TrendFocus Information Services. Their Storage Demand Analysis Service 2006 annual report forecast the disk drive industry to grow at 14.4% compounded annual rate (in unit terms) through 2010, approaching 750 million units by that time. Consumer-driven devices such as personal video recorders (PVRs), MP3 audio devices (e.g., iPod), game consoles, multi-function printers, automobile intelligence systems (AIS), digital still cameras (DSC), and a host of other new digital products are fueling