XYRATEX LTD
Form 20-F
February 20, 2008

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

As filed with the Securities and Exchange Commission on February 20, 2008

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

ý **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)**

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:

29,237,057 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 ý

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 ý

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 ý 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 ý Non-accelerated filer o

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

Item 17 o Item 18 ý

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 ý

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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.

	Year Ended November 30,				
	2007	2006	2005	2004	2003
	(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
Total revenues	931,633	983,633	679,609	459,014	333,769
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)
Total gross profit	169,051	197,286	144,294	94,629	73,059
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
Total research and development	77,559	71,391	54,327	55,388	32,225
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
Total selling, general and administrative	61,977	60,449	38,842	164,368	76,569
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
Total operating expenses	146,840	136,963	99,617	224,165	120,419
Operating income (loss)	22,211	60,323	44,677	(129,536)	(47,360)
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	26,384	64,652	45,853	(128,484)	(47,569)
Provision (benefit) for income taxes	(1,725)	6,474	3,964	(6,239)	(11,754)
Net income (loss) from continuing operations	28,109	58,178	41,889	(122,245)	(35,815)
Income (loss) from discontinued operations			280	(12,924)	(20,194)
Gain (loss) from sale of discontinued operations					(185)
Net income (loss)	$ 28,109	$ 58,178	$ 42,169	$ (135,169)	$ (56,194)

	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)

(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.

	As of November 30,				
	2007	2006	2005	2004	2003
	(U.S. dollars in thousands)				
Consolidated Balance Sheet Data:					
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
Total debt		7,000	14,000	17,000	19,133
Total shareholders' equity	$ 273,261	$ 234,494	$ 161,382	$ 116,701	$ 19,001
Number of shares issued and outstanding:					
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.

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 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 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).

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.

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.

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 (square feet)	Manufacturing space (square feet)	Total space (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
Total		244,000	244,000	488,000

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

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%

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.

	Year Ended November 30,		Increase/(Decrease)	
	2007	2006	Amount	%
	(US dollars in thousands)			
Revenues:				
Networked Storage Solutions	$ 693,990	$ 598,752	$ 95,238	15.9%
Storage Infrastructure	237,643	384,881	(147,238)	(38.3)
Total revenues	931,633	983,633	(52,000)	(5.3)
Cost of revenues non cash equity compensation	1,238	923	315	
Cost of revenues other	761,344	785,424	(24,080)	(3.1)
Gross profit:				
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)	
Total gross profit	169,051	197,286	(28,235)	(14.3)
Operating expenses:				
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)	
Net income from continuing operations	$ 28,109	$ 58,178	$ (30,069)	(51.7)%

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.

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)			
Revenues:				
Networked Storage Solutions	$ 598,752	$ 415,379	$ 183,373	44.1%
Storage Infrastructure	384,881	264,230	120,651	45.7
Total revenues	983,633	679,609	304,024	44.7
Cost of revenues non cash equity compensation	923		923	
Cost of revenues other	785,424	535,315	250,109	46.7
Gross profit:				