XYRATEX LTD
Form 6-K
October 17, 2006

U.S. SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 6-K

**REPORT OF FOREIGN PRIVATE ISSUER
PURSUANT TO RULE 13a-16 OR 15d-16 UNDER
THE SECURITIES EXCHANGE ACT OF 1934**

October 17, 2006

XYRATEX LTD

(Registrant s name)

Langstone Road

Havant

PO9 1SA

United Kingdom

(Address of Principal Executive Offices)

Indicate by check mark whether the registrant files annual reports under cover of Form 20-F or Form 40-F.

Form 20-F x Form 40-F o

Indicate by check mark whether the registrant by furnishing the information contained in this Form is also thereby furnishing the information to the Commission pursuant to Rule 12g3-2(b) under the Securities Exchange Act of 1934.

Yes o No x

NEWS RELEASE

Havant, UK October 17, 2006 - Xyratex Ltd (Nasdaq: XRTX) today released the following financial information for the third quarter of its 2006 fiscal year, ending August 31, 2006:

- Management s Discussion and Analysis of Financial Condition and Results of Operations
- Unaudited condensed consolidated financial statements

1

MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

This section contains forward-looking statements. These statements relate to future events or our future financial performance and involve known and unknown risks, uncertainties and other factors that may cause our actual results, levels of activity, performance or achievements to differ materially from any future results, levels of activity, performance or achievements expressed or implied by these forward-looking statements. These risks and other factors include those listed under Risk Factors and elsewhere in our Annual Report on Form 20-F as filed with the Securities and Exchange Commission. In some cases, you can identify forward-looking statements by terminology such as may, will, should, expects, intends, plans, anticipates, believes, estimates, predicts, potential, continue, or the negative of these terms or other comp terminology. Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, performance or achievements.

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: Storage and Network Systems and Storage Infrastructure.

Our Storage and Network Systems 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 2005 fiscal year, sales to our top three customers, Network Appliance, Seagate Technology and Western Digital accounted for 48%, 30% and 7% of our revenues, respectively. In the nine months ended August 31, 2006, sales to these customers accounted for 83% of our revenues. We had 39 customers which individually contributed more than $0.5 million to revenues in our 2005 fiscal year and at August 31, 2006 we had over 130 active customers. We enter into joint development projects with our key customers and suppliers in order to research and introduce new technologies and products.

Acquisitions and disposals

Subsequent to the quarter end, 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 $1.5 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.

On June 30, 2006 we acquired from IBM a portfolio of 49 US patents and related filings in other countries for consideration of $4.0 million. The portfolio included specific patent clusters related to Snapshot, Advanced Memory Caching and Raid Controller technology in support of the future product roadmap requirements of our Storage and Network Systems segment. This represents a significant injection of intellectual property and will enable us to build more value add features and functions to the technology acquired as part of the acquisition of nStor Technologies, Inc. in September 2005.

On March 6, 2006, we concluded the disposal of a product line through a license of the intellectual property of certain network analysis technology and the transfer of the related customer base to Napatech, a programmable network adapter company based in Denmark. We will continue to manufacture the related product lines for Napatech under a separate Supply Agreement. The license agreement required an initial payment of $2.0 million and further payments equal to the amount of revenue that is derived from the transferred customers during the twelve months from March 1, 2006, in excess of $2.0 million and up to a maximum of $7.5 million. Revenue from these customers totaled approximately $5.7 million in the year ended November 30, 2005.

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 developer and provider of data storage subsystems, primarily to OEMs. We are in the process of integrating nStor s business with our Storage and Network Systems segment. 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. We are

anticipating improvements in operating results related to this business during our 2006 fiscal year through increased revenues and operating efficiencies through synergies with our Storage and Network Systems segment.

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

Revenues

We derive revenues primarily from the sale of our Storage and Network Systems products and our Storage Infrastructure products.

Our Storage and Network Systems products consist primarily of storage subsystems which address three market segments through our OEM customers; Network Attached Storage or NAS, Storage Area Networks or SAN and Nearline 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. Nearline storage is considered to be a new segment within the external storage systems market. It is primarily driven by magnetic tape technology being replaced by storage systems containing low cost disk drive technology in the back up and recovery processes within enterprises. The deployment of low cost disk drives is also taking place within the SAN and NAS market segments as IT departments begin to classify their data as part of an information life cycle or corporate data management strategy. Our customers in each market segment currently use the fibre channel protocol to access the storage subsystem which can incorporate either high performance fibre channel or lower cost ATA/SATA disk drives.

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

As described below, 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. In the last three fiscal years we have not seen an overall trend in our unit prices.

Revenues from product sales are recognized once delivery has occurred, provided that there is persuasive evidence that an arrangement exists, the price for the delivered product is fixed or determinable, and it is reasonably assured that the revenue will be collected. Delivery is considered to have occurred when title and risk of loss have been transferred to the customer. For sales that include customer-specified acceptance criteria, revenues are recognized after the acceptance criteria have been met. Sales of the major portion of our Storage Infrastructure products include an installation element. Revenue for these products is recognized upon installation except that, where there is objective and reliable evidence to support the fair value of installation, or where there is a separate arrangement for the installation, product revenue is recognized upon delivery. In addition, some of our sales contracts provide that a certain percentage of payments is to be made in advance of product delivery, in which case we record these payments as deferred revenue until the product is actually delivered.

We 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. Some of these arrangements require non-refundable payments from our customers for research and development during the product development phase, which is known as non-recurring engineering or NRE . Revenue from non-recurring engineering under these contracts has been recognized upon the achievement of agreed project milestones and amounted to $0.8 million in our 2005 fiscal year and $1.6 million in the nine months ended August 31, 2006. These amounts exclude compensation for product development received on cancellation of a customer order as described below in the discussion of revenue in the nine months ended August 31, 2006. We do

3

not anticipate any significant changes in the level of revenue from non-recurring engineering.

We believe that both of our business segments present the opportunity for growth. We are seeing growth in demand from our customers, which we believe relates to factors including increases in the amount of digitally stored information, increased information technology spending, growth in the specific markets which our customers address, the trend towards outsourcing and increased market share of our customers. Growth in our Storage Infrastructure revenues is also specifically affected by the growth in shipped volume and increases in the individual storage capacity of disk drives. The acquisition of Maxtor by Seagate Technology in May 2006 represents a significant consolidation among disk drive suppliers and has caused significant changes in market share. Whilst the opportunity for growth in the longer term remains, the revenue trend over the next several quarters has become significantly more difficult to forecast.

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 Storage and Network Systems 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. We seek to improve our gross margins by delivering higher value-added products to our customers.

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 2005 fiscal year our research and development expenses related to over approximately 39 separate projects relating to improving existing products, meeting customer specific requirements and entering new markets, such as development of the Application Storage System.

As of November, 2005 27% of our employees were engaged in our research and development activities and this proportion has not changed significantly in 2006. Over recent fiscal years research and development expenses have risen approximately in line with the increase in revenue and we expect this trend to continue, reflecting our continuing commitment to developing products based on advanced technologies and designs.

Selling, General and Administrative

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

Provision for Income Taxes

We are subject to taxation primarily in the United Kingdom, the United States and Malaysia. After excluding equity compensation expense, over 90% of our income before income taxes in the last two fiscal years has arisen in the United Kingdom or Malaysia. Since 1998, our Malaysian operations have benefited from high-tech pioneer status which provided us with a zero tax rate on substantially all of our income arising in Malaysia. In 2006 we have been granted a tax exempt status for our operations in Malaysia until 2012. This removes the risk which previously existed, of a rise in our overall tax rate which would have occurred in 2007 when our high-tech pioneer status was due to expire. As of November 30, 2005, we had a loss carryforward of $22.6 million in the United Kingdom and as a result of these loss carry-forwards have not been required to make any significant U.K. tax payments in recent fiscal years.

As of November 30, 2005, we recorded a deferred tax asset of $24.0 million. Of this amount, $14.6 million

4

relates to a loss carryforward and other tax and accounting timing differences in the United Kingdom. Of the remaining balance $5.2 million relates to non-cash equity compensation expense as described in the next paragraph and $3.7 million relates to net operating loss carryforwards recorded in connection with our acquisition of nStor.

As a result of the recording of a non-cash equity compensation expense in our 2004 fiscal year related to our Initial Public Offering in that year, we recorded an additional deferred tax asset of $12.3 million relating to share options granted to U.K. employees. As of November 30, 2005, as a result of employees exercising share options, $7.1 million of this amount had been added to U.K. loss carryforwards. This tax benefit primarily relates to a U.K. tax deduction which is obtained when these share options are exercised, calculated as the excess of the market price on date of exercise over the exercise price. Following the adoption of FAS 123R described below, any future windfall tax benefits will only be recognized when they are realized through a benefit to cash flow. A significant proportion of the equity compensation expense calculated using the fair value method of FAS 123R results in the recording of a tax benefit and this benefit will form the baseline for calculating any future windfall tax benefits.

Tax payments in our 2005 fiscal year amounted to $1.7 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 2006 fiscal year. The tax expense we recorded in the nine months ended August 31, 2006 primarily relates to a reduction in the deferred tax asset arising from the usage of U.K. operating loss carryforwards.

Equity Compensation Expense

In our 2006 fiscal year we are required to record equity compensation expense using the fair value method required by Financial Accounting Standard (FAS) 123R Share Based Payment . Under our previous accounting policy we recorded equity compensation expense using the intrinsic value method prescribed by Accounting Principles Board Opinion (APB) 25 Accounting for Stock Issued to Employees . Equity compensation expense calculated under FAS 123R for the nine months ended August 31, 2006 was $5.4 million and we also recorded an income tax benefit related to this expense of $1.3 million. The net effect therefore amounted to $4.0 million and resulted in a reduction in our basic and diluted earnings per share. We anticipate recording $9.5 million in equity compensation expense over our next four fiscal years for share and option awards outstanding as of August 31, 2006. We also anticipate that this will increase as a result of the granting of additional share based awards in future periods and change as a result of changes in assumptions on which the calculation of the equity compensation expense is based.

We recorded an expense of $0.6 million in the nine months ended August 31, 2005 related to 0.3 million share awards based on the prorated vesting of those shares during the period and calculated under our previous accounting policy.

Results from Operations

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

	Three Months Ended August 31,				**Nine Months Ended August 31,**			
	2006		**2005**		**2006**		**2005**	
Revenues	100.0	%	100.0	%	100.0	%	100.0	%
Cost of revenues	78.9		79.8		79.1		79.0	
Gross profit	21.1		20.2		20.9		21.0	
Operating expenses:								
Research and development	6.9		8.6		7.3		7.9	
Selling, general and administrative	6.0		5.7		6.0		5.7	
Amortization of intangible assets	0.5		0.5		0.5		0.3	
In process research and development							0.5	
Operating income	7.8		5.4		7.1		6.7	
Net income	6.8		4.8		6.6		6.0	
Segment gross profit as a percentage of segment revenues:								
Storage and Network Systems	14.1	%	15.2	%	14.1	%	15.7	%
Storage Infrastructure	30.5	%	29.1	%	30.5	%	29.6	%

Three Months Ended August 31, 2006 Compared to Three Months Ended August 31, 2005

The following is a tabular presentation of our results of operations for the three months ended August 31, 2006 compared to the three months ended August 31, 2005. Following the table is a discussion and analysis of our business and results of operations for such periods.

	Three Months Ended August 31, 2006	**August 31, 2005**	**Increase / (Decrease) Amount**	**%**
	US dollars in thousands			
Revenues:				
Storage and Network Systems	$ 148,566	$ 104,757	$ 43,809	41.8 %
Storage Infrastructure	114,572	59,161	55,411	93.7
Total revenues	263,138	163,918	99,220	60.5
Cost of revenues	207,488	130,788	76,700	58.6
Gross profit:				
Storage and Network Systems	20,933	15,895	5,038	31.7
Storage Infrastructure	34,999	17,235	17,764	103.1
Equity compensation	(282)		(282)	
Total gross profit	55,650	33,130	22,520	68.0
Operating expenses:				
Research and development	18,061	14,062	3,999	28.4
Selling, general and administrative	15,764	9,404	6,360	67.6
Amortization of intangible assets	1,318	834	484	
In process research and development				
Operating income	20,507	8,830	11,677	132.2
Other income				
Interest income, net	429	351	78	
Provision for income taxes	3,125	1,324	1,801	136.0
Net income	$ 17,811	$ 7,857	$ 9,954	126.7 %

Revenues

The 60.5% increase in our revenues in the three months ended August 31, 2006 compared to the three months ended August 31, 2005 was attributable to increased sales of both our Storage and Network Systems and Storage Infrastructure products.

Of the $43.8 million increase in revenues from sales of our Storage and Network Systems products, management estimates that $20.0 million was contributed by an 87% increase in revenues from products incorporating low-cost disk drives. The remaining increase related primarily to growth of approximately 27% in sales of our storage subsystem products incorporating fibre channel disk drives. Both of these increases were driven largely by a continued growth in our sales to Network Appliance and we believe this reflects the increasing requirements for storage of digital information, particularly networked storage.

The $55.4 million increase in revenues from sales of Storage Infrastructure products primarily resulted from an increase of $49.5 million in revenues from sales of production test systems. In addition revenues from the sale of servo track writers and media process technology increased by $4.0 million and $1.9 million, respectively. As described above, our revenues from our Storage Infrastructure products are subject to significant fluctuations, particularly between quarters, resulting from our major customers capital expenditure decisions and installation schedules. Management believe that, in addition to underlying growth in demand, the increase in revenues resulted from expansion of capacity by our customers as a result of the acquisition of Maxtor by Seagate and from an expansion of disk media production capacity in the environment of an ongoing constraint in the supply of disk media.

Cost of Revenues and Gross Profit

The increase in cost of revenues and gross profit in the three months ended August 31, 2006 compared to the three months ended August 31, 2005 was primarily related to our growth in revenues. As a percentage of revenues, excluding the non-cash equity compensation expense, our gross profit was 21.3% in the three months ended August 31, 2006 compared to 20.2% for the three months ended August 31, 2005. This reflects an increase of 1.1% resulting from an increased proportion of higher margin Storage Infrastructure revenues and an increase in the gross margin related to Storage Infrastructure products. The effect of these factors was partially offset by a decrease in the gross margin for our Storage and Network Systems products.

The gross margin for our Storage and Network Systems products decreased to 14.1% in the three months ended

August 31, 2006 from 15.2% in the three months ended August 31, 2005, primarily as a result of changes in product and customer mix, in particular the increasing proportion of revenues related to the lower margin disk drive component

The gross margin for Storage Infrastructure products was 30.5% in the three months ended August 31, 2006, compared to 29.1% in the three months ended August 31, 2005. The increase in gross margin was primarily related to the benefit of operating efficiencies with the higher levels of revenue. The gross margin in each quarter also varies with changes in product mix, but there were no individually significant changes in product mix resulting in changes to gross margin in these quarters.

In measuring the performance of our business segments from period to period without variations caused by special or unusual items, we focus on gross profit by product group, which excludes a non-cash equity compensation charge of $0.3 million for the three months ended August 31, 2006. See Note 12 to our condensed consolidated financial statements for a description of our segments and how we measure segment performance.

Research and Development

The $4.0 million increase in research and development expense in the three months ended August 31, 2006 compared to the three months ended August 31, 2005 includes a $0.6 million increase in equity compensation expense resulting primarily from the implementation of FAS123R as described above, $0.9 million relating to additional employee performance related bonuses and approximately $1.0 million related to the operations of nStor. In addition the increase included increased investment of approximately $1.6 million in a number of projects to enhance the technology content and broaden the range of our storage subsystems, and $1.2 million related to increased investment in all of our significant Storage Infrastructure product lines. In November 2005 we ceased investment in silicon based switch architecture and the effect of this was to reduce our research and development expense by $1.3 million from that in the comparative quarter.

Selling, General and Administrative

The $6.4 million increase in our selling, general and administrative expense in the three months ended August 31, 2006 compared to the three months ended August 31, 2005 includes a $1.2 million increase in equity compensation expense resulting primarily from the implementation of FAS123R, additional employee performance related bonuses of $1.0 million and approximately $1.0 million related to the operations of nStor. The remaining increase relates primarily to an increase in the number of employees engaged in sales and distribution activities in support of the increase in the level of business.

Amortization of Intangible Assets

The $0.5 million increase in amortization of intangible assets in the three months ended August 31, 2006 includes $0.3 million from the amortization of intangible assets purchased as part our acquisition of nStor on September 9, 2005 and $0.1 million from the amortization of patents acquired from IBM on June 30, 2006.

Interest Income, Net

We recorded net interest income of $0.4 million in the three months ended August 31, 2006, essentially unchanged from $0.4 million in the three months ended August 31, 2005 reflecting the effect of an increase in interest rates offset by the effect of a decrease in average cash balances, primarily related to cash used in our acquisition of nStor.

Provision for Income Taxes

During the three months ended August 31, 2006 we recorded a provision for income taxes of $3.1 million compared with $1.3 million in the three months ended August 31, 2005. This was primarily as a result of the increase in income before income taxes.

Net Income

The increase in net income for the three months ended August 31, 2006 compared to the three months ended August 31, 2005 resulted primarily from an increase in revenues and an overall increase in gross margin. This was offset by factors set out above, including, in particular, the increase in operating expenses, including the effect of our acquisition of nStor and $1.3 million related to an increase in equity compensation expense.

Nine Months Ended August 31, 2006 Compared to Nine Months Ended August 31, 2005

The following is a tabular presentation of our results of operations for the nine months ended August 31, 2006

7

compared to the nine months ended August 31, 2005. Following the table is a discussion and analysis of our business and results of operations for such periods.

	Nine Months Ended August 31, 2006	August 31, 2005	Increase / (Decrease) Amount	%
	US dollars in thousands			
Revenues:				
Storage and Network Systems	$ 431,134	$ 294,179	$ 136,955	46.6 %
Storage Infrastructure	311,403	181,866	129,537	71.2
Total revenues	742,537	476,045	266,492	56.0
Cost of revenues	587,289	375,981	211,308	56.2
Gross profit:				
Storage and Network Systems	60,948	46,145	14,803	32.1
Storage Infrastructure	94,943	53,919	41,024	76.1
Equity compensation	(643)		(643)	
Total gross profit	155,248	100,064	55,184	55.1
Operating expenses:				
Research and development	53,925	37,482	16,443	43.9
Selling, general and administrative	44,582	27,104	17,478	64.5
Amortization of intangible assets	3,693	1,560	2,133	
In process research and development		2,230	(2,230)	
Operating income	53,048	31,688	21,360	67.4
Other income	1,965		1,965	
Interest income, net	867	1,020	(153)	
Provision for income taxes	7,056	4,358	2,698	61.9
Net income	$ 48,824	$ 28,350	$ 20,474	72.2 %

Revenues

The 56.0% increase in our revenues in the nine months ended August 31, 2006 compared to the nine months ended August 31, 2005 was attributable to increased sales of both our Storage and Network Systems and Storage Infrastructure products.

Of the $137.0 million increase in revenues from sales of our Storage and Network Systems products, management estimates that $51.0 million was contributed by a 78% increase in revenues from products incorporating low-cost disk drives. The remaining increase related primarily to growth of approximately 34% in sales of our storage subsystem products incorporating fibre channel disk drives. Both of these increases were driven largely by a continued growth in our sales to Network Appliance and we believe this reflects the increasing requirements for storage of digital information, particularly networked storage.

The $129.5 million increase in revenues from sales of Storage Infrastructure products included increases in revenues from each of our product groups. Revenues from the sale of media process technology increased by $46.2 million, including the contribution of $25.1 million for the first two quarters of 2006 from sales of media cleaning equipment following our acquisition of Oliver Design in May 2005. Revenues from sales of production test systems and servo track writers increased by $61.3 million and $22.0 million, respectively. As described above, our revenues from our Storage Infrastructure products are subject to significant fluctuations, particularly between quarters, resulting from our major customers capital expenditure decisions and installation schedules. Management believe that, in addition to underlying growth in demand, the increase in revenues resulted from expansion of capacity by our customers as a result of the acquisition of Maxtor by Seagate and from an expansion of disk media production capacity in the environment of an ongoing constraint in the supply of disk media. Included in revenues is a $10.5 million charge to Maxtor for the cancellation of an order for production test systems, being compensation for product development costs and supply chain liabilities.

Cost of Revenues and Gross Profit

The increase in cost of revenues and gross profit in the nine months ended August 31, 2006 compared to the nine months ended August 31, 2005 was primarily related to our growth in revenues. As a percentage of revenues, excluding the non-cash equity compensation expense, our gross profit was 21.0% in the nine months ended August 31, 2006 which is essentially unchanged from the 21.0% for the nine months ended August 31, 2005. This reflects an increase in the gross margin for our Storage Infrastructure products and an increase of 0.5% resulting from an increased proportion of higher margin Storage Infrastructure revenues offset by a decrease in the gross margin for our Storage and

8

Network Systems products.

The gross margin for our Storage and Network Systems products decreased to 14.1% in the nine months ended August 31, 2006 from 15.7% in the nine months ended August 31, 2005, primarily as a result of changes in product and customer mix, in particular the increasing proportion of revenues related to the lower margin disk drive component. In addition, the gross margin in this segment reduced by 0.2% as a result of an increase in provisions against inventory which is not compliant with new European hazardous substances laws.

The gross margin for Storage Infrastructure products was 30.5% in the nine months ended August 31, 2006, compared to 29.6% in the nine months ended August 31, 2005. The increase in gross margin was primarily related to the benefit of operating efficiencies with the higher levels of revenue. The gross margin in each quarter also varies with changes in product mix, but there were no individually significant changes in product mix resulting in changes to gross margin in these periods.

In measuring the performance of our business segments from period to period without variations caused by special or unusual items, we focus on gross profit by product group, which excludes a non-cash equity compensation charge of $0.6 million for the nine months ended August 31, 2006. See Note 12 to our condensed consolidated financial statements for a description of our segments and how we measure segment performance.

Research and Development

The $16.4 million increase in research and development expense in the nine months ended August 31, 2006 compared to the nine months ended August 31, 2005 includes a $1.4 million increase in equity compensation expense resulting primarily from the implementation of FAS123R as described above, $0.9 million relating to additional employee performance related bonuses, approximately $3.6 million related to the operations of nStor and $3.7 million related to media cleaning technology as a result of our acquisition of Oliver Design in May 2005. In addition the increase included increased investment of approximately $6.5 million in a number of projects to enhance the technology content and broaden the range of our storage subsystems and $3.9 million related to increased investment in all of our significant Storage Infrastructure product lines. In November 2005 we ceased investment in silicon based switch architecture and the effect of this was to reduce our research and development expense by $3.6 million from that in the comparative period.

Selling, General and Administrative

The $17.4 million increase in our selling, general and administrative expense in the nine months ended August 31, 2006 compared to the nine months ended August 31, 2005 includes a $2.7 million increase in equity compensation expense resulting primarily from the implementation of FAS123R, additional employee performance related bonuses of $1.3 million, a $0.8 million accounts receivable provision and the effects of our acquired businesses, including $3.0 million related to the nStor business and $2.0 million relating to the Oliver Design business. The remaining increase relates primarily to an increase in the number of employees engaged in sales and distribution activities in support of the increase in the level of business.

Amortization of Intangible Assets

The $2.1 million increase in amortization of intangible assets in the nine months ended August 31, 2006 relates primarily to the effects of our acquisitions of nStor on September 9, 2005 and Oliver Design on May 23, 2005.

In Process Research and Development

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

Other Income

We recorded income of $2.0 million in the nine months ended August 31, 2006 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 $0.9 million in the nine months ended August 31, 2006 compared to $1.0 million in the nine months ended August 31, 2005. This decrease resulted from a decrease in average cash balances, primarily related to cash used in our acquisition of nStor, partially offset by the effect of an increase in the interest rate.

Provision for Income Taxes

During the nine months ended August 31, 2006 we recorded a provision for income taxes of $7.1 million compared with $4.4 million in the nine months ended August 31, 2005. This was primarily as a result of the increase in income before income taxes offset by an adjustment to prior year liabilities of $1.5 million arising from the grant of tax free status in Malaysia and the agreement of certain prior year U.K. tax filings.

Net Income

The increase in net income for the nine months ended August 31, 2006 compared to the nine months ended August 31, 2005 resulted primarily from an increase in revenues, including that from acquired businesses. The income from the disposal of a product line and the adjustment to prior year tax liabilities also contributed to the increase in net income. This was offset by factors set out above, including, in particular, the decrease in gross margins in our Storage and Network Systems segment and the increase in operating expenses, including the effect of our acquisitions and $3.4 million related to an increase in equity compensation expense.

Liquidity and Capital Resources

Cash flows

Net cash provided by operating activities was $33.2 million for the nine months ended August 31, 2006 compared to $20.5 million in the nine months ended August 31, 2005.

Cash provided by operating activities of $33.2 million for the nine months ended August 31, 2006 resulted primarily from the positive contribution of net income of $48.8 million after excluding net non-cash charges totaling $16.4 million together with increases in accounts payable and deferred revenue of $40.1 million and $3.6 million respectively. The increase in accounts payable resulted primarily from the increase in revenues. Deferred revenue represents advance payments from customers for Storage Infrastructure products and varies with the level of orders on hand for these products. A decrease in deferred income taxes of $7.1 million and an increase in other accrued liabilities of $3.8 million also contributed to operating cash flow. The decrease in deferred income taxes related primarily to the usage of U.K. net operating loss carry-forwards. The increase in other accrued liabilities resulted primarily from an increase in liabilities to suppliers for an order cancellation. These positive effects on cash flows were partially offset by increases in accounts receivable and inventories of $32.1 million and $56.2 million, respectively. The increase in inventories results from an increase in the levels of revenue and changes to installation schedules by our disk drive manufacturer customers. The increase in accounts receivable resulted from an increase in revenues.

Cash provided by operating activities of $20.5 million for the nine months ended August 31, 2005 resulted primarily from the positive contribution of net income after excluding non-cash charges of $6.5 million together with increases in accounts payable and deferred revenue of $14.1 million and $5.6 million respectively, and a decrease in deferred income taxes of $5.2 million. The increase in accounts payable results primarily from underlying sales growth. The increase in deferred revenue resulted primarily from an increase in orders on hand for Storage Infrastructure products where payments are made in advance of shipment. The decrease in deferred income taxes related primarily to the usage of U.K. net operating loss carryforwards. These positive effects on cash flows were partially offset by increases in accounts receivable and inventories of $11.4 million and $26.7 million, respectively, resulting primarily from growth in the business.

Net cash used in investing activities was $27.5 million for the nine months ended August 31, 2006 compared to $18.6 million for the nine months ended August 31, 2005.

Net cash used in investing activities for the nine months ended August 31, 2006 included $8.0 million deferred consideration related to our acquisition of ZT Automation in 2004, $15.6 million related to capital expenditure and $4.0 million related to the acquisition of a portfolio of patents from IBM on June 30, 2006. Net cash used in the nine months ended August 31, 2005 comprised $14.2 million initial consideration for the Oliver Design acquisition less cash acquired of $10.3 million, $2.5 million deferred consideration related to the ZT Automation acquisition and $9.7 million related to capital expenditure. In addition cash used in investing activities included a loan of $2.5 million to nStor Technologies in advance of our acquisition of the company on September 9, 2005.

Our capital expenditures relate primarily to purchases of equipment such as tooling, production lines and test equipment. In addition, in July 2005 we commenced a new project to replace our Enterprise and Resource Planning (ERP) system. This will result in additional capital expenditure of approximately $9.0 million in our 2005, 2006 and 2007 fiscal years, of which $2.6 million and $3.8 million, respectively is included in capital expenditure in the nine

10

months ended August 31, 2006 and our 2005 fiscal year. With this exception, we do not anticipate any significant changes in the nature or level of our capital expenditures and we would expect these to generally increase in line with our revenues. With the exception of the new ERP system, we currently have no material commitments for capital expenditures.

Net cash used in financing activities was $2.9 million in the nine months ended August 31, 2006 and $3.0 million in the nine months ended August 31, 2005.

Net cash used in financing activities for the nine months ended August 31, 2006 comprises quarterly repayments totaling $3.0 million under our HSBC term loan and payments of $3.0 million deferred consideration for the acquisition of Oliver Design offset by $3.1 million proceeds from the exercise of employee share options. Net cash used in financing activities in the nine months ended August 31, 2005 comprises the payment of a $2.0 million acquisition note payable related to our acquisition of ZT Automation in 2004 and quarterly repayments totaling $3.0 million under our HSBC term loan, partially offset by $2.0 million proceeds from the exercise of employee share options.

Liquidity

As of August 31, 2006, our principal sources of liquidity consisted of cash and cash equivalents of $44.0 million and our multi-currency credit facilities with HSBC. The HSBC credit facilities include the remaining $8.0 million of a $19.0 million term loan. This loan is repayable in equal quarterly installments over approximately five years. The facilities also include a revolving line of credit which expires in December 2008, and a short-term overdraft facility. The revolving line of credit is for an aggregate principal amount of up to $30.0 million and bears interest at a rate of between 0.6% and 1.25% above LIBOR, depending on the level of debt relative to operating income. The overdraft facility is for an aggregate principal amount of $15.0 million and bears interest at a rate equal to 0.75% above LIBOR. As of August 31, 2006, we had no debt outstanding under our revolving line of credit or our overdraft facility. The HSBC credit facilities provide for a security interest on substantially all of our assets.

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

Accounting Policies

Critical Accounting Policies

Our critical accounting policies are set out in our Annual Report on form 20-F as filed with the Securities and Exchange Commission. By critical accounting policies we mean policies that are both important to the portrayal of our financial condition and financial results and require critical management judgments and estimates about matters that are inherently uncertain. Although we believe that our judgments and estimates are appropriate, actual future results may differ from our estimates.

Following the adoption of FAS 123R described above we now believe that our policy for the accounting for share based payment is a critical accounting policy. FAS 123R requires the measurement and recognition of compensation for all share based awards made to employees and directors, including share options, employee share purchases and restricted share awards, based on estimated fair values. Under FAS 123R, we use the Black-Scholes option pricing model as our method of valuation for share-based awards. Our determination of the fair value of share-based awards on the date of grant using an option pricing model is affected by our share price as well as assumptions regarding a number of highly complex and subjective variables. These variables include, but are not limited to the expected life of the award, our expected share price, volatility over the term of the award, expected forfeiture levels and actual and projected exercise patterns. Although the fair value of share-based awards is determined in accordance with FAS 123R, the Black-Scholes option pricing model requires the input of highly subjective assumptions, and other reasonable assumptions could provide differing results.

Recent Accounting Pronouncements

In March 2005, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin (SAB) 107, which offers guidance on FAS 123R. SAB 107 was issued to assist preparers by simplifying some of the implementation challenges of FAS 123R while enhancing the information that investors receive. SAB 107 creates a framework that is premised on two overarching themes: (a) considerable judgment will be required by preparers to

11

successfully implement FAS 123R, specifically when valuing employee stock options; and (b) reasonable individuals, acting in good faith, may conclude differently on the fair value of employee stock options. Key topics covered by SAB 107 include valuation models, expected volatility and expected term. In October 2005, the FASB issued FSP FAS 123(R)-2, Practical Accommodation to the Application of Grant Date as Defined in FAS 123(R) . In November 2005, the FASB issued FSP FAS 123(R)-3, Transition Election Related to Accounting for the Tax Effects of Share-Based Payment Awards . In February 2006, the FASB issued FSP FAS 123(R)-4, Classification of Options and Similar Instruments Issued as Employee Compensation that Allow for Cash Settlement on the Occurrence of a Contingent Event . These interpretations provide further guidance on the implementation of FAS123R as set out in their respective titles. We have applied the principles of SAB 107 and these interpretations in conjunction with our adoption of FAS 123R. We do not expect FAS123(R)-4 to have a material impact on our financial condition or results of operations.

In March 2005, the FASB issued Interpretation No. 47, Accounting for Conditional Asset Retirement Obligations (FIN 47), which states that a company must recognize a liability for the fair value of a legal obligation to perform asset retirement activities that are conditional on a future event if the amount can be reasonably estimated. FIN 47 clarifies that conditional obligations meet the definition of an asset retirement obligation in FAS No. 143, Accounting for Asset Retirement Obligations , and therefore should be recognized if their fair value is reasonably estimable. FIN 47 is effective no later than the end of the first fiscal year ending after December 15, 2005, and has been adopted by us beginning December 1, 2005. We do not expect the adoption of this interpretation to have a material effect on our financial condition or results of operations.

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

In June 2005, the Emerging Issues Task Force (EITF) reached consensus on Issue No. 05-6, *Determining the Amortization Period for Leasehold Improvements* (EITF 05-6.). EITF 05-6 provides guidance on determining the amortization period for leasehold improvements acquired in a business combination or acquired subsequent to lease inception. The guidance in EITF 05-6 will be applied prospectively and is effective for periods beginning after June 29, 2005. Adoption of this standard is not expected to have a material impact on our financial position or results of operations.

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

In September 2005, the FASB issued EITF Issue No. 04-13, Accounting for Purchases and Sales of Inventory with the Same Counterparty (EITF 04-13). The issue provided guidance on the circumstances under which two or more inventory transactions with the same counterparty should be viewed as a single nonmonetary transaction within the scope of APB Opinion No. 29, Accounting for Nonmonetary Transactions. The issue also provided guidance on circumstances under which nonmonetary exchanges of inventory within the same line of business should be recognized at fair value. EITF 04-13 will be effective for transactions completed in reporting periods beginning after March 15, 2006. Adoption of this standard is not expected to have a material impact on our financial position or results of operations.

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

In September 2006, the SEC issued SAB 108 which provides interpretive guidance on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a current year misstatement. If the effect of initial adoption is determined to be material, the cumulative effect may be reported as an adjustment to the beginning of year retained earnings with disclosure of the nature and amount of each individual error being corrected in the cumulative adjustment. The guidance is applicable in our 2006 fiscal year. We will apply this guidance in assessing any future misstatements.

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

13

XYRATEX LTD

UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS

	August 31, 2006	November 30, 2005