

XYRATEX LTD
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(US dollars and amounts in thousands, except per share data, unless otherwise stated)

1. The Company and its Operations

Xyratex Ltd together with its subsidiaries (“the Company”) is a leading provider of modular enterprise-class data storage subsystems and storage process technology with principal operations in the United Kingdom (“U.K.”), the United States of America (“U.S.”) and Malaysia. We operate in two business segments: Networked Storage Solutions (“NSS”) and Storage Infrastructure (“SI”). Our NSS products are hard disk drive based data storage subsystems. Our SI products include disk drive production test and qualification systems, media write systems, cleaning and contamination control equipment and automation and factory control technology.

2. Basis of Presentation

The accompanying interim condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States.

These condensed consolidated financial statements are unaudited but include all adjustments (consisting of normal recurring adjustments) which the Company’s management considers necessary for a fair presentation of the financial position as of such dates and the operating results and cash flows for those periods presented. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States have been condensed or omitted. In addition, the results of operations for the interim periods may not necessarily be indicative of the operating results that may be incurred for the entire year.

The November 30, 2009 balance sheet was derived from audited consolidated financial statements but does not include all disclosures required by accounting principles generally accepted in the United States. However, the Company believes that the disclosures are adequate to make the information presented not misleading. These unaudited condensed consolidated financial statements should be read in conjunction with the Company’s audited consolidated financial statements included in the Company’s Form 20-F as filed with the Securities and Exchange Commission on February 23, 2010.

3. Equity compensation plans

The following table summarizes equity compensation expense related to share-based awards:

	Three months ended February 28, 2010	Three months ended February 28, 2009
Equity compensation:		
Cost of revenues.....	\$351	\$265
Research and development	718	510
Selling, general and administrative.....	1,088	755
Total equity compensation	2,157	1,530
Related income tax benefit	\$-	\$-

The Company’s share based awards primarily consist of Restricted Stock Units (“RSUs”). The Company has also operated an Employee Share Purchase Plan (“ESPP”) for U.S. employees and a Sharesave option plan for U.K. employees. The Company suspended new awards under the ESPP and the Sharesave plan during 2009 due to the volatility in its share price, but expects to resume awards in 2010. Prior to 2006 share based awards were primarily in the form of share options. Based on an agreement with the Company’s managing underwriter for the Initial Public Offering in 2004, there are 1,737 shares authorized for future grants under the plans. Option exercises are satisfied through the issue of new shares or where previously agreed with the trustee, through the transfer of shares from an employee benefit trust.

Restricted Stock Units

RSUs generally require that shares be awarded over four years from the date of grant, subject to continued service. The vesting of these units is also generally subject to the achievement of certain performance conditions in the year of grant. Equity compensation expense relating to RSUs totaling \$2,130 has been recorded in the three months ended February 28, 2010. Restricted stock units granted, exercised, canceled and expired are summarized as follows

	<u>RSU</u>	<u>Weighted- Average Grant Date Fair Value</u>	<u>Weighted- Average Remaining Contractual Term (years)</u>	<u>Aggregate Intrinsic Value</u>
Non-vested restricted stock units at November 30, 2009	1,430	9.67		
Granted	856	13.54		
Vested	(527)	8.90		
Cancelled/forfeited	(8)	18.33		
Non-vested restricted stock units at February 28, 2010	<u>1,752</u>	<u>10.96</u>	<u>2.2</u>	
Non-vested restricted stock units expected to vest at February 28, 2010..	<u>1,564</u>	<u>10.95</u>	<u>2.1</u>	<u>\$20,655</u>

Share Option Activity

The Company has four plans under which employees were granted options to purchase Xyratex Ltd shares prior to 2006. Options exercised, canceled or forfeited under all of the Company's share option plans, excluding the Sharesave Plan, are summarized as follows:

	<u>Options</u>	<u>Weighted- Average Exercise Price</u>	<u>Weighted- Average Remaining Contractual Term (years)</u>	<u>Aggregate Intrinsic Value</u>
Outstanding at November 30, 2009	1,240	10.46		
Exercised	(170)	2.78		
Forfeited	(1)	14.31		
Outstanding at February 28, 2010.....	<u>1,069</u>	<u>11.56</u>	<u>3.9</u>	<u>\$2,617</u>
Exercisable at February 28, 2010	<u>1,069</u>	<u>11.56</u>	<u>3.9</u>	<u>\$2,617</u>

Exercise prices of option activity and options outstanding denominated in U.K. pounds have been converted to the U.S. dollar equivalent in the above table using the U.K. pound/U.S. dollar exchange rate as of each transaction date or period end date as appropriate.

Employee Stock Purchase Plan and Sharesave plan

No shares were granted under the Employee Stock Purchase Plan in the three months ended February 28, 2010. There were no movements in options granted under the Sharesave plan in three months ended February 28, 2010

4. Net earnings per share

Basic net earnings per share for the three month periods ended February 28, 2010 and February 28, 2009 is computed by dividing net income by the weighted-average number of common shares. Diluted net earnings per share gives effect to all potentially dilutive common share equivalents outstanding during the period. The effect of 294 common share equivalents was excluded from the diluted weighted average shares outstanding in the three month period ended February 28, 2009, because their inclusion would be anti-dilutive due to the net loss recorded for the period.

	Number of common shares	
	Three months ended	
	February 28, 2010	February 28, 2009
Total weighted average common shares – basic	29,719	29,236
Dilutive effect of share options.....	126	-
Dilutive effect of restricted stock units.....	917	-
Total weighted average common shares – diluted	30,762	29,236

5. Restructuring costs

On December 4, 2008 and March 26, 2009 the Company announced details of cost reduction programs in response to worsening market conditions resulting from upheaval in the financial credit markets. This included a compulsory headcount reduction program and the closure of certain Company locations, primarily supporting research and development. The Company reduced its overall employee numbers by approximately 13%. The costs of employee and lease terminations totaled \$5,898. \$4,142 related to employee terminations and \$1,756 to lease terminations which expire in 2010 and 2011. Of these amounts \$3,116 was incurred in the three months ended February 28, 2009. This program was completed and all amounts paid by February 28, 2010 with the exception of lease costs totaling \$937.

6. Financial instruments

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

Forward foreign exchange contracts and options

Over 90% of the Company's revenues are denominated in the U.S. dollar, whereas certain expenses are incurred in U.K. pounds and Malaysian Ringgits. Therefore, the Company is exposed to foreign currency exchange rate risk which creates volatility in income and cash flows from period to period. In part, the Company manages this exposure through entering into forward foreign exchange contracts and options to reduce the volatility of income and cash flows associated with this risk. The Company designated all of its forward foreign currency contracts as qualifying for cash flow hedge accounting. Changes in the fair value of these instruments are deferred and recorded as a component of accumulated other comprehensive income (AOCI) until the hedged transactions affect earnings, at which time the deferred gains and losses on the forward foreign currency contracts are recognized in the income statement. The Company enters into these foreign exchange contracts to hedge a portion of its forecasted foreign currency denominated expense in the normal course of business and accordingly, they are not speculative in nature. The counterparty to the foreign currency contracts is an international bank. Such contracts are for two years or less at inception.

The Company reclassified a gain of \$951 from AOCI to earnings during the three months ended February 28, 2010 due to the realization of the underlying transactions. Such amounts were recorded as cost of sales, research and development expense or selling, general and administrative expense in proportion to the cash flow being hedged. The Company recorded the change in fair market value of derivatives related to its cash flow hedges, the balances of which are recorded in other current assets, to AOCI of \$2,926 for the three months ended February 28, 2010. For the three months ended February 28, 2009 the Company recorded in other current assets, movements to AOCI of \$3,161. No taxation applies to these amounts due to the recording of a valuation allowance against U.K. deferred tax assets.

The following table summarizes the foreign currency derivative contract activity during the period:

	<u>Number of contracts</u>
At November 30, 2009	26
Matured during the period	(6)
New contracts entered into during the period	<u>8</u>
At February 28, 2010	<u>28</u>

The fair value of derivative instruments and their location in the consolidated balance sheet as of 28 February 2010 and November 30, 2009 were as follows:

Derivatives designated as hedging instruments:	<u>Balance Sheet Location</u>	<u>February 28, 2010</u>	<u>November 30, 2009</u>
Asset derivatives	Other current assets	\$ -	\$ 3,524
Liability derivatives	Other accrued liabilities	\$ 255	\$ -

The effect of derivative instruments designated as cash flow hedges on the condensed consolidated statement of operations for the three months ended February 28, 2010 was as follows:

Derivatives in Cash Flow Hedging Relationships	<u>Gain (Loss) Recognized ⁽¹⁾</u>	<u>Gain (Loss) Reclassified ⁽²⁾</u>
Foreign exchange contracts.....	\$ (2,926)	\$ 951

(1) Amount recognized in AOCI (effective portion).

(2) Amount of gain (loss) reclassified from AOCI into income (effective portion) located in expense.

Unrealized gains and losses reported in AOCI will be reclassified to earnings as the forecast expenditures for which the foreign exchange contracts have been entered into arise. It is estimated that all of the unrealized amounts in respect of foreign exchange contracts are expected to be reclassified to earnings during the next twenty months.

The following table shows derivatives existing as of February 28, 2010 and November 30, 2009:

Derivatives between U.K. pound and U.S. dollar	<u>February 28, 2010</u>	<u>November 30, 2009</u>
Forward exchange contracts and options (notional value).....	\$ 46,109	\$ 36,209
Average rate of contract	\$ 1.54	\$ 1.51
Period end rate	\$ 1.52	\$ 1.65
Maximum period of contracts (months)	20	11
 Derivatives between Malaysian ringgit and U.S. dollar	 	
Forward exchange contracts and options (notional value).....	\$ 4,500	\$ 6,000
Average rate of contract	\$ 0.29	\$ 0.28
Period end rate	\$ 0.29	\$ 0.30
Maximum period of contracts (months)	6	10

Fair values

The carrying values of all financial instruments, including forward foreign exchange contracts, approximate their fair values. Assets and liabilities required to be carried at fair value will be classified and disclosed in one of the following three categories:

Level 1: Quoted market prices in active markets for identical assets or liabilities.

Level 2: Observable market based inputs or unobservable inputs that are corroborated by market data.

Level 3: Unobservable inputs that are not corroborated by market data.

The following table presents the Company's assets and liabilities measured at fair value on a recurring basis as of February 28, 2010 and at November 30, 2009 aggregated by the level in the fair-value hierarchy within which those measurements fall:

	February 28, 2010		November 30, 2009	
	Total	Significant Other Observable Inputs (Level 2)	Total	Significant Other Observable Inputs (Level 2)
Foreign currency forward contracts—asset (liability) position	\$ (255)	\$ (255)	\$ 3,524	\$ 3,524

The Company's forward foreign exchange contracts and options are measured on a recurring basis based on foreign currency spot rates and forward rates quoted by banks (level 2 criteria) and are marked-to-market each period with gains and losses on these contracts recorded in Other Comprehensive Income with the offsetting amount for unsettled positions being included in either other current assets or other accrued liabilities in the balance sheet.

7. Concentration of credit risk

Financial instruments which potentially subject the Company to concentrations of credit risk include cash and cash equivalents, short-term investments and accounts receivable. The Company places its cash and cash equivalents and short-term investments with high-credit quality financial institutions. Cash deposits are generally placed with either one or two institutions and such deposits, at times, exceed governmentally insured limits. Concentrations of credit risk, with respect to accounts receivable, exist to the extent of amounts presented in the financial statements. Three customers, each with balances greater than 10% of total accounts receivable, represented 72% of the total accounts receivable balance at February 28, 2010 and three customers represented 73% of the total accounts receivable balance at November 30, 2009. Generally, the Company does not require collateral or other security to support customer receivables. The Company performs periodic credit evaluations of its customers and maintains an allowance for potential credit losses based on historical experience and other information available to management. Losses to date have been within management's expectations.

During the three months ended February 28, 2010 revenues from three customers represented 71% of total revenues and during the three months ended February 28, 2009, revenues from two customer represented 66% of total revenues. No other customer accounted for more than 10% of revenues.

8. Identified intangible assets

	February 28, 2010	November 30, 2009
Existing technology.....	\$8,193	\$8,193
Patents and core technology	10,800	10,800
Customer relationships.....	4,305	4,305
	23,298	23,298
Accumulated amortization.....	(17,072)	(16,091)
	\$6,226	\$7,207

9. Inventories

	<u>February 28,</u> <u>2010</u>	<u>November 30,</u> <u>2009</u>
Finished goods	\$35,363	\$25,182
Work in progress.....	34,337	19,970
Raw materials	89,071	63,473
	<u>\$158,771</u>	<u>\$108,625</u>

10. Income Taxes

The provision for income taxes for the three month periods ended February 28, 2010 and February 28, 2009 is based on the Company's current estimate of effective tax rates on U.S. income of 39%, the rate being based on a forecast of income before income taxes in the years ended November 30, 2009 and November 30, 2010. U.K. losses or income are excluded from the effective rate calculation due to the recording of the valuation allowance in the 2008 fiscal year. During the three months ended February 28, 2010 there have been no changes to management's estimates in connection with income tax items in the balance sheet including the balance of unrecognized tax benefits.

11. Product warranty liability

The Company generally offers warranties between one and three years. Estimated future warranty obligations related to product sales are charged to operations in the period in which the related revenue is recognized. These estimates are based on historical warranty experience and other relevant information of which the Company is aware.

The following table provides the changes in the product warranty accrual for the three months ended February 28, 2010:

	<u>Amount of</u> <u>liability</u>
Balance at November 30, 2009:	\$3,537
Accruals for warranties issued during the period	1,418
Settlements made during the period	<u>(876)</u>
Balance at February 28, 2010:	<u>\$4,079</u>

12. Segment Information

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

Description of the Company's segments:

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

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

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

	Three Months Ended	
	February 28, 2010	February 28, 2009
Revenues:		
NSS.....	\$270,983	\$165,725
SI.....	\$47,983	\$18,160
Total Segments.....	<u>\$318,966</u>	<u>\$183,885</u>
Gross profit:		
NSS.....	\$41,313	\$18,389
SI.....	\$16,636	\$2,768
Total Segments.....	\$57,949	\$21,157
Equity Compensation (note 3)	<u>\$351</u>	<u>\$265</u>
Total	<u>\$57,598</u>	<u>\$20,892</u>
Depreciation and amortization:		
NSS.....	\$3,161	\$3,306
SI.....	\$1,370	\$1,459
Total Segments.....	\$4,531	\$4,765
Corporate	<u>\$907</u>	<u>\$694</u>
Total.....	<u>\$5,438</u>	<u>\$5,459</u>

Total segments revenues represent revenues as reported by the Company for all periods presented. Gross profit above represents gross profit as reported by the Company for all periods presented. The chief operating decision maker does not review asset information by segment and therefore no asset information is presented.