

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

Our NSS products are primarily hard disk drive (HDD) based storage subsystems, which we provide to OEMs and our SI 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 2009 fiscal year, sales to our top six customers, NetApp, Dell, IBM, Seagate Technology, Western Digital and Data Domain accounted for 87% of our revenues with sales to NetApp and Dell accounting for 48% and 15% of our revenues, respectively. These were also our top six customers in the three months ended February 28, 2010, and accounted for 90% of our revenues with sales to NetApp, Dell and Seagate accounting for 43%, 17% and 11% of our revenues, respectively. We had 33 customers which individually contributed more than \$0.5 million to revenues in our 2009 fiscal year. We enter into joint development projects with our key customers and suppliers in order to research and introduce new technologies and products.

### **Revenues**

We derive revenues primarily from the sale of our NSS products and our SI products. The sales of products in both these segments are impacted by underlying increases in the amount of digitally stored information.

Our NSS products consist primarily of HDD based storage subsystems. Our modular subsystem architecture enables us to support many segments within the networked storage market through our OEM customer base. Our revenues are primarily dependent on the worldwide storage systems market, the market share of our OEM customer base, particularly that of key customers, and changes in that customer base.

Our SI 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 four main product lines in this segment: disk drive production test and qualification systems; media write systems; cleaning and contamination control equipment; and automation and factory control technology. Our SI revenues are specifically affected by changes in shipped volume and increases in the individual storage capacity of disk drives. 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.

In our 2009 fiscal year, our NSS and SI revenues were impacted by the effects of upheaval in the financial markets on the macro-economic environment. This impact was particularly severe for the SI business as the disk drive manufacturers scaled back their production capacity in response to lower demand, particularly for personal computers. We saw customer demand increase in the second half of 2009 as underlying market conditions improved both for enterprise and consumer storage and that trend has continued into the first quarter of 2010 with a particularly significant increase in customer orders and forecast demand for SI products.

Over at least the past five years we have seen underlying growth in demand for NSS products from many of our OEM customers, which we believe relates to factors including increases in the amount of digitally stored information, increased IT spending, growth in the specific markets that our customers address and an increased market share of our customers. Commencing in 2009 we enabled our largest customer, NetApp, to source a proportion of the products we supply from an alternative supplier. This proportion is set at a maximum of 25% in our next two fiscal years, but will increase in later fiscal years. Over the longer term our revenues with our major customers will significantly depend on our ability to develop and manufacture products which compete well with those provided by contract manufacturers and these customers' own development efforts.

### ***Cost reduction exercise***

We undertook a cost reduction exercise in the first half of 2009, in response to the changed economic environment in the final quarter of 2008. This exercise, which was completed in 2009, included a 13.1% reduction in our worldwide employee headcount, including an 18.2% reduction in our combined U.S. and U.K. employee headcount. The cost reduction activities resulted in restructuring costs of approximately \$6 million and annual cost savings compared to the costs that would have been incurred without the cost reduction exercise, of approximately \$32 million, of which approximately \$13 million relates to cost of revenues and the remainder relates to other operating expenses. Expenses are expected to increase in 2010 to support a significant increase in customer demand. This increase includes reinstating staff benefits such as the annual profit related bonus as well as an increase in headcount across our locations.

### ***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 \$64 million in our 2009 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. We have hedged the majority of our exposure to this exchange rate movement for approximately one year ahead and we are particularly impacted by the movement in average annual exchange rates in the prior fiscal year. The average value of the U.K. pound relative to the U.S. dollar declined by 20% from 2008 to 2009. This movement will reduce 2010 operating expenses by approximately \$11 million, subject to the impact of future movement of exchange rates on those expenses which are not hedged.

### ***Gross Profit***

Our gross profit 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, provisions for obsolescence, manufacturing volumes and costs of components. The margins for our NSS products tend to be lower than the margins of our SI 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***

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 2009 fiscal year our research and development expenses related to over 40 separate projects covering improving existing products, meeting customer specific requirements and entering new markets, such as development of the SBB compliant OneStor platform and a production test system designed specifically for 2.5 inch disk drives.

Over recent fiscal years research and development expenses have changed approximately in line with changes in revenue. Although we reduced expenditure in 2009 as part of the cost reduction exercise, we continued to develop our technology base to support our customers and be able to take advantage of the market improvements that we are now experiencing. We are committed to developing products based on advanced technologies and designs to support the opportunities for growth in both of our segments and expect to increase our expenditure in 2010 to support our customers' growing demand and further expand these opportunities.

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

We are subject to taxation primarily in the United Kingdom, the United States and Malaysia. Our Malaysian operations relating to SI and NSS products benefit from a beneficial tax status which has provided us with a zero tax rate on substantially all of our income arising in Malaysia. The beneficial tax status relating to SI products was granted in 2006 and ends in 2012. The beneficial tax status relating to NSS products was granted in February 2009 and will cover a period of ten years from 2007. The beneficial tax status for both SI and NSS products is subject to meeting certain requirements.

We have significant loss carryforwards and other deferred tax assets in the United Kingdom and as a result we have not been required to make any significant U.K. tax payments in recent fiscal years. As of November 30, 2009 we recorded a \$33.9 million valuation allowance against the book value of U.K. deferred tax assets at that date and as a result our tax provision relates primarily to U.S. operations.

In the United Kingdom and the United States we benefit from research and development tax credits although benefitting from these credits in the U.K. is dependent on the reversal of the valuation allowance against the U.K. deferred tax asset.

As of February 28, 2010, we retained a deferred tax asset of \$6.7 million related to loss carryforwards and other timing differences in the United States.

## **Results from Continuing Operations**

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

	<b><u>Three Months Ended</u></b>	
	<b><u>February 28,</u></b> <b><u>2010</u></b>	<b><u>February 28,</u></b> <b><u>2009</u></b>
Revenues .....	100.0%	100.0%
Cost of revenues .....	81.9	88.6
Gross profit.....	18.1	11.4
Operating expenses:		
Research and development.....	5.7	10.2
Selling, general and administrative .....	3.6	7.5
Amortization of intangible assets .....	0.3	0.5
Restructuring costs .....	—	1.7
Operating income (loss) .....	8.4	(8.6)
Net income (loss) .....	8.2	(8.8)
Segment gross profit as a percentage of segment revenues:		
Networked Storage Solutions .....	15.2	11.1
Storage Infrastructure.....	34.7%	15.2%

### Three Months Ended February 28, 2010 Compared to the three Months Ended February 28, 2009

The following is a tabular presentation of our results of operations for the three months ended February 28, 2010 compared to the three months ended February 28, 2009. Following the table is a discussion and analysis of our business and results of operations for such periods.

	Three months ended		Increase/(Decrease)	
	February 28, 2010	February 28, 2009	Amount	%
(U.S. dollars in thousands)				
Revenues:				
Networked Storage Solutions .....	\$270,983	\$165,725	\$105,258	63.5
Storage Infrastructure .....	47,983	18,160	29,823	164.2
Total revenues.....	318,966	183,885	135,081	73.5
Cost of revenues .....	261,368	162,993	98,375	60.4
Gross profit:				
Networked Storage Solutions .....	41,313	18,389	22,924	124.7
Storage Infrastructure .....	16,636	2,768	13,868	501.0
Non cash equity compensation .....	(351)	(265)	(86)	—
Total gross profit.....	57,598	20,892	36,706	175.7
Operating expenses:				
Research and development .....	18,115	18,747	(632)	(3.4)
Selling, general and administrative.....	11,572	13,827	(2,255)	(16.3)
Amortization of intangible assets.....	978	966	12	—
Restructuring costs.....	—	3,116	(3,116)	—
Operating income (loss).....	26,933	(15,764)	42,697	—
Interest income (expense), net .....	(24)	60	(84)	—
Provision for income taxes .....	632	424	208	—
Net income (loss).....	\$26,277	\$(16,128)	\$42,405	—

#### Revenues

The 73.5% increase in our revenues in the three months ended February 28, 2010 compared to the three months ended February 28, 2009 was attributable to increased sales of our NSS and SI products.

Revenues from sales of our NSS products increased by \$105.3 million, or 63.5%. This was due to increased demand from all of our major OEM customers and reflects a recovery in the market for data storage following the significant decline in the first quarter of 2009 related to the economic downturn. Revenue in the fourth quarter of our 2009 fiscal year was negatively impacted by an estimated \$10 million to \$20 million due to constraints on the supply of certain components, particularly semi-conductors. This arose because suppliers cut back capacity in response to the economic downturn. Although these component shortages are continuing due to further increases in customer demand they have had only a small impact on revenue in the first quarter of 2010.

Revenues from sales of our SI products increased by \$29.8 million, or 164.2%. Demand for SI products in the first quarter of 2009 was at historically very low levels due to our disk drive manufacturer customers reducing production capacity as a result of the economic downturn. The increase in revenues included increased sales of a number of our product lines including \$19.1 million for production test and qualification systems and \$8.9 million for media write technologies.

#### Cost of Revenues and Gross Profit

The increase in cost of revenues and in gross profit in the three months ended February 28, 2010 compared to the three months ended February 28, 2009 was primarily due to higher NSS and SI revenues. As a percentage of revenues, our gross profit was 18.1% for the three months ended February 28, 2010 compared to 11.4% for the three months ended February 28, 2009. This change was primarily attributable to the effect of fixed costs relative to higher revenues and also increased by 1% as a result of the increased proportion of SI revenues.

The gross margin for our NSS products increased to 15.2% in the three months ended February 28, 2010 from 11.1% in the three months ended February 28, 2009. This increase included an improvement of 2.0% due to effect of fixed costs relative to increased revenues. The remaining increase resulted from a number of changes to product mix, the most significant of which was the impact of lower disk drive costs where the margin is a fixed dollar amount per unit.

The gross margin for SI products increased to 34.7% in the three months ended February 28, 2010, from 15.2% in the three months ended February 28, 2009. This increase primarily resulted from the effect of fixed costs relative to higher 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 \$0.4 million for the three months ended February 28, 2010 and \$0.3 million for the three months ended February 28, 2009. See Note 12 to our unaudited condensed consolidated financial statements for a description of our segments and how we measure segment performance.

#### *Research and Development*

The \$0.6 million or 3.4% decrease in research and development expense in the three months ended February 28, 2010 compared to the three months ended February 28, 2009 resulted primarily from a \$1.9 million impact of the decrease in the value of the U.K. pound relative to the U.S. dollar. The impact of this was partially offset by an increase in expenses related to actual and anticipated growth in the business including employee bonuses of \$0.5 million.

#### *Selling, General and Administrative*

Selling, general and administrative expense decreased by \$2.3 million in the three months ended February 28, 2010 compared to the three months ended February 28, 2009. The decrease primarily results from a \$2.0 million impact of the decrease in the value of the U.K. pound relative to the U.S. dollar. The remaining decrease was due to the cost reduction exercise partially offset by increased costs related to the higher revenues including a \$0.8m increase in employee bonuses.

#### *Restructuring costs*

The \$3.1 million of restructuring costs in the three months ended February 28, 2009 resulted from the cost reduction exercise described in the overview and related to employee reductions and lease terminations.

#### *Provision for Income Taxes*

The provision for income taxes primarily relates to estimated U.S. income, as described in the overview.

#### *Net Income (Loss)*

The most significant contributor towards the recording of net income of \$26.3 million for the three months ended February 28, 2010 compared to a net loss of \$16.1 million for the three months ended February 28, 2009, was the significant increase in revenues in both segments and the resulting increase in gross margin. In addition, operating expenses reduced by approximately \$6m, due primarily to the recording of restructuring costs in the prior year and changes in exchange rates.

### **Liquidity and Capital Resources**

We finance our operations primarily through cash balances and cash flow from operations. We also have available bank facilities from HSBC.

#### *Cash flows*

Net cash provided by operating activities was \$5.0 million in the three months ended February 28, 2010, compared to \$10.3 million in the three months ended February 28, 2009.

Cash provided by operating activities of \$5.0 million for the three months ended February 28, 2010 resulted primarily from net income and non-cash charges totaling \$33.9 million partially offset by an increase in working capital of \$25.1 million. The increase in working capital related to an increase in actual and forecast revenues and included increases in inventory and accounts receivable of \$50.1 million and \$76.8 million respectively partially offset by increases in accounts payable and deferred revenue of \$84.4 million and \$13.6 million respectively. Deferred revenue primarily represents advance payments from customers for SI products and varies with the level of orders on hand for these products.

Cash provided by operating activities of \$10.3 million for the three months ended February 28, 2009 resulted primarily from a reduction in working capital related to the reduction in revenues. This included a decrease in inventory and accounts receivable of \$16.6 million and \$54.4 million respectively offset by a decrease in accounts payable of \$44.9

million and a decrease in deferred revenues of \$3.2 million. These positive effects on cash flow were partially offset by the net loss of \$16.1 million after excluding net non-cash charges totaling \$7.0 million.

Net cash used in investing activities, relating to capital expenditure, was \$3.7 million for the three months ended February 28, 2010, and \$4.6 million for the three months ended February 28, 2009.

Our capital expenditures relate primarily to purchases of equipment such as tooling, production lines and test equipment and in 2009 also included a building expansion in Malaysia. We would expect our capital expenditure to generally change in line with our revenues.

Net cash provided by our financing activities was \$0.5 million in the three months ended February 28, 2010 and \$0.1 million in the three months ended February 28, 2009, both amounts being proceeds from the exercise of employee share options.

### *Liquidity*

As of February 28, 2010, our principal sources of liquidity consisted of cash and cash equivalents of \$53.7 million and our multi-currency credit facilities with HSBC. The facilities include a revolving line of credit which expires in October 2011, 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 2.5% and 3.0% above LIBOR, depending on the level of debt relative to operating income. The overdraft facility is for an aggregate principal amount of \$25.0 million and bears interest at a rate equal to 3% above LIBOR. As of February 28, 2010, 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 our ability to generate profits, changes in revenues and associated working capital requirements, changes in the payment terms with our major customers and suppliers of disk drives, and quarterly fluctuations in our revenues. Additionally, our cash flow could be significantly affected by any acquisitions we might choose to make or alliances we have entered or might enter into. We believe that our cash and cash equivalents together with our credit facilities with HSBC will be sufficient to meet our cash requirements at least through the next 12 months. However, 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 on February 23, 2010. 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.

### ***Recent Accounting Pronouncements***

In December 2007, the FASB issued new accounting guidance related to business combinations. This guidance retains the fundamental requirements requiring that the purchase method be used for all business combinations. It defines the acquirer as the entity that obtains control of one or more businesses in the business combination, establishes the acquisition date as the date that the acquirer achieves control and requires the acquirer to recognize the assets acquired, liabilities assumed and any noncontrolling interest at their fair values as of the acquisition date. In addition, the new guidance requires expensing of acquisition-related and restructure-related costs, remeasurement of earn out provisions at fair value, measurement of equity securities issued for purchase at the date of close of the transaction and non-expensing of in-process research and development related intangibles. These requirements are effective for any business combinations we may make in our 2010 fiscal year.

In June 2009, the FASB issued new guidance relating to the accounting for transfers of financial assets. The purpose of this guidance is to improve the relevance, representational faithfulness, and comparability of the information that a reporting entity provides in its financial statements about a transfer of financial assets; the effects of a transfer on its financial position, financial performance, and cash flows; and a transferor's continuing involvement, if any, in transferred financial assets. These requirements are effective for Xyratex for transfers occurring on or after 1 December 2009. The adoption of this guidance did not have a material impact on our consolidated financial statements.

In June 2009, the FASB issued new guidance relating to the consolidation of variable interest entities. This guidance changes how a company determines when an entity that is insufficiently capitalized or is not controlled through voting (or similar rights) should be consolidated and requires a company to provide additional disclosures about its involvement with variable interest entities and any significant changes in risk exposure due to that involvement. This guidance is effective for interim and annual periods beginning after November 15, 2009. The adoption of this guidance did not have a material impact on our consolidated financial statements.

In October 2009 the FASB issued new guidance related to revenue recognition for arrangements with multiple deliverables and those which include software elements. The issues address certain aspects of the accounting by the vendor that involve more than one deliverable or unit of accounting. The guidance will allow companies to allocate arrangement consideration in multiple deliverable arrangements in a manner that better reflects the transaction's economics and will remove non-software components of tangible products and certain software components of tangible products from the scope of existing software revenue guidance. For contracts with software elements this will result in the recognition of revenue similar to that for other tangible products. This guidance is effective for annual periods beginning after June 15, 2010. Early adoption is permitted and may be prospective or retrospective. We are currently evaluating the impact of the adoption of these requirements, but do not expect the adoption to have a material impact on our consolidated financial statements.

In January 2010, the FASB issued revised guidance on disclosures related to fair value measurements. This guidance requires new disclosures about significant transfers in and out of Level 1 and Level 2 and separate disclosures about purchases, sales, issuances, and settlements with respect to Level 3 measurements. The guidance also clarifies existing fair value disclosures about valuation techniques and inputs used to measure fair value. The new disclosures and clarifications of existing disclosures are primarily effective for us in our 2010 fiscal year. The adoption of this revised guidance did not have a material impact on our consolidated financial statements.