

PEER 1 NETWORK ENTERPRISES INC. MANAGEMENT DISCUSSION & ANALYSIS FOR THE YEAR ENDED JUNE 30, 2005

This Management Discussion and Analysis ("MD&A"), dated October 6, 2005, should be read in conjunction with Peer 1's audited annual financial statements for the fiscal year ended June 30, 2005 and the notes thereto. All figures noted are in Canadian dollars.

FORWARD-LOOKING STATEMENTS

This discussion and analysis includes certain forward-looking statements in respect to the future performance of our business, its operations, financial position and condition including upcoming events. These forward-looking statements are based upon current expectations which involve risks and uncertainties that could cause actual outcomes and results to differ materially. Factors that could cause or contribute to such differences include, but are not limited to, general economic conditions, changes in technology, general sales risks, and limited intellectual property protection. Other risks and uncertainties are described in a subsequent section of this filing. The company assumes no obligation to revise any forward looking statements to reflect new events or circumstances.

PEER 1 NETWORK ENTERPRISES OVERVIEW

Fiscal Year 2005 Highlights

- 77% increase in annual revenues from \$13.6 million to \$24.1 million.
- Gross profit margins increase from 36.5% to 38.9%.
- Loss for the year increased from \$1.0 million in 2004 to \$2.5 million in 2005.
- EBITDA for the year was \$3.7 million compared to \$0.9 million for 2004, an increase of 325%.
- Completed the acquisition of the assets of ServerBeach Ltd., a dedicated server provider.
- Opened a new colocation facility in Herndon, Virginia to serve the eastern USA dedicated server operations of ServerBeach Ltd., as well as for Peer 1 colocation and bandwidth operations.
- Substantially completed the move of approximately 2,800 dedicated servers from a facility operated by the former owners of ServerBeach to the new Peer 1 facility in Herndon.

Core Business

Peer 1 Network Enterprises Inc. ("Peer 1") provides high performance internet bandwidth and co-location facilities to web-centric customers across North America. Building on a redundant, 100% Cisco powered internal network, Peer 1 guarantees 100% uptime internet access for companies with mission-critical applications. The company has established local offices and data centres in Vancouver, Toronto, Montreal, New York, Seattle, San Jose, San Antonio and Herndon VA and also has points of presence (POPs) in the USA in Ashburn VA, Chicago and Los Angeles, and in the UK in London.

Bandwidth

Peer 1's bandwidth service is provided by way of an expandable network which is connected to multiple globally based providers in Canada, the US and the UK and which utilizes hundreds of peering partners to ensure continuous internet connectivity, greater route diversity, and ultimately, enhanced internet performance. Traffic generated from and received by our customers is charged for on a per unit basis, except for those who have committed to minimum usage levels.

Colocation

The co-location service provided by Peer 1 involves the physical locating of a customer's switching gear or servers in one of the dedicated facilities operated by Peer 1, which is designed to provide the infrastructure necessary for the functioning of that equipment. Included in the required infrastructure would be such resources as a secured cage or cabinet, regulated power, emergency backup power, dedicated Internet connection, regulated air temperature and security.

The major benefits of co-location with Peer 1 are:

- Significantly reduced costs of staff, facilities and hardware
- Reduced configuration and management issues
- Access to a high bandwidth, high quality IP network
- 24 hours, 7 days a week monitoring
- An environmentally protected facility
- High level of physical security

Colocation customers are charged for the service provided by way of a monthly rental charge.

Dedicated Servers

In addition to its core business, Peer 1 offers through its subsidiary, ServerBeach, which was recently awarded Web Host Magazine's "Editor's Choice" in the hosting category, self-managed, competitively price dedicated server solutions to small and mid-size businesses, and technology hobbyists. ServerBeach provides Linux and Microsoft users with high-performance servers, complete with a full set of easy-to-use developer's tools.

STRATEGY

Peer 1's management is implementing a three-level growth strategy initiative. The three elements of the strategy initiative are organic growth, leveraged growth, and accelerated growth. The organic growth strategy seeks to add more customers and expand the network's reach into key peering points worldwide. The leveraged growth strategy seeks growth by introducing new products and services that leverage the infrastructure that Peer 1 has already has. Peer 1's accelerated growth strategy focuses on actively pursuing acquisitions that are accretive to the Peer 1.

Network

Peer 1 has built a series of dedicated links between all of Peer 1's facilities using multiple high-speed connections. Hundreds of peering relationships and traffic exchange agreements have been established with other networks. The peering arrangements are fundamental to the company's strategy. Peering is a relationship between two or more networks of any size in which the networks create a direct link between each other and agree to forward each other's packets directly across this link instead of using the standard Internet backbone. This has two main advantages: first, it reduces latency between the two networks; and secondly, it avoids additional costs associated with a third party network.

Colocation Facilities

Peer 1's strategy is to establish a point of presence in a new market by colocating in facilities owned by other suppliers, in order to gauge market demand, prior to making a decision to open up a new colocation facility. When a market is deemed to be viable, the company identifies suitable space for long term lease. Wherever possible, sites that have previously been operated as data centres are sought, since this reduces the initial capital investment required. All equipment is acquired and installed on a phased basis, again to reduce the capital investment required. As market share grows, additional equipment is acquired.

Dedicated Servers

The strategy for Peer 1's ServerBeach brand of unmanaged dedicated servers is to provide servers built with quality parts at the lowest possible cost. By using automated provisioning and billing processes and leveraging the existing network, the company has been able to maintain a low cost structure that supports the price-driven strategy.

ANNUAL INFORMATION

Segmented Information

As this is the first year for which the reported results include the operations of ServerBeach, the following additional financial information is provided to facilitate comparisons to previous periods.

Peer 1 Network Enterprises, Inc. Segmented Balance Sheet As At June 30, 2005 (unaudited - prepared by management)				
	6/30/2005 Peer 1	6/30/2005 ServerBeach	6/30/2005 Total	6/30/2004 Peer 1
Assets				
Current:				
Cash and cash equivalents	685,978	284,560	970,538	976,848
Accounts receivable	2,991,503	-	2,991,503	2,139,565
Inventory	-	102,829	102,829	-
Prepaid expenses	362,475	98,111	460,586	305,724
	4,039,956	485,500	4,525,456	3,422,137
Other assets	1,273,573	-	1,273,573	794,804
Property, plant and equipment	8,621,599	3,867,564	12,489,163	5,300,519
Goodwill, licences and other intangibles	-	5,865,724	5,865,724	-
	13,935,128	10,218,788	24,153,916	9,517,460
Liabilities				
Current Liabilities				
Accounts payable and accrued liabilities	4,847,931	781,226	5,629,157	2,201,583
Deferred revenue	854,158	541,996	1,396,154	571,156
Current portion of deferred lease inducements	59,962	-	59,962	11,800
Current portion of notes payable	3,662,680	9,804,800	13,467,480	510,289
Shareholder notes	2,756,245	-	2,756,245	1,315,341
	12,180,976	11,128,022	23,308,998	4,610,169
Deferred lease inducements	384,772	-	384,772	150,431
Notes payable	119,228	-	119,228	3,319,312
	12,684,976	11,128,022	23,812,998	8,079,912
Shareholders' Equity (Deficiency)				
Capital Stock	11,245,992	-	11,245,992	9,914,432
Warrants	-	-	-	-
Contributed Surplus	636,056	-	636,056	435,638
Equity component of convertible debt	435,638	-	435,638	220,355
Retained Earnings (Deficit)	(11,067,534)	(909,234)	(11,976,768)	(9,132,877)
	1,250,152	(909,234)	340,918	1,437,548
	13,935,128	10,218,788	24,153,916	9,517,460

Peer 1 Network Enterprises, Inc.
Segmented Income Statement
Three Months Ended June 30
(unaudited - prepared by management)

	Three Months Ended June 30, 2005 Peer 1	Three Months Ended June 30, 2005 ServerBeach	Three Months Ended June 30, 2005 Total	Three Months Ended June 30, 2004 Peer 1
Revenue	4,541,111	2,929,581	7,470,692	3,667,290
Cost of Sales	3,065,259	1,410,228	4,475,487	2,413,332
Gross Profit	1,475,852	1,519,353	2,995,205	1,253,958
Operating expenses	1,788,184	684,444	2,472,628	1,318,417
Operating profit (loss)	(312,332)	834,909	522,577	(64,459)
Amortization of licences	-	310,849	310,849	-
Interest expense	215,405	629,648	845,053	510,923
Interest accretion on convertible debt	94,222	-	94,222	(402,410)
Integration costs	-	38,078	38,078	-
Realized foreign exchange loss (gain)	(24,569)	-	(24,569)	32,366
Unrealized foreign exchange loss (gain)	(69,041)	23,529	(45,512)	39,576
Loss from equity accounted investment	195,568	-	195,568	-
Income (loss) before income taxes	(723,917)	(167,195)	(891,112)	(244,914)
Provision for income taxes	(7,714)	(21,608)	(29,322)	-
Income (loss) for the period	(716,203)	(145,587)	(861,790)	(244,914)
Deficit, beginning of period	(10,351,331)	(763,647)	(11,114,978)	(8,887,963)
Adjustment for prior years' stock based compensation	-	-	-	-
Deficit, end of period	(11,067,534)	(909,234)	(11,976,768)	(9,132,877)
EBITDA	162,848	1,091,473	1,254,321	124,530
Normalized EBITDA	162,848	1,129,551	1,292,399	124,530

Peer 1 Network Enterprises, Inc.
Segmented Income Statement
Year To Date
(unaudited - prepared by management)

	Year Ended June 30, 2005 Peer 1	Year Ended June 30, 2005 ServerBeach (since Oct 20/04)	Year Ended June 30, 2005 Total	Year Ended June 30, 2004 Peer 1
Revenue	16,992,638	7,120,710	24,113,348	13,587,914
Cost of Sales	10,846,267	3,880,995	14,727,262	8,622,363
Gross Profit	6,146,371	3,239,715	9,386,086	4,965,551
Operating expenses	6,548,919	1,651,792	8,200,711	5,003,234
Operating profit (loss)	(402,548)	1,587,923	1,185,375	(37,683)
Amortization of licences	-	789,897	789,897	-
Interest expense	756,258	1,506,640	2,262,898	626,501
Interest accretion on convertible debt	371,727	-	371,727	326,322
Integration of ServerBeach	-	384,525	384,525	-
Realized foreign exchange loss (gain)	(75,076)	-	(75,076)	(37,732)
Unrealized foreign exchange loss (gain)	(69,041)	(183,905)	(252,946)	39,576
Loss from investment accounted for on an equity basis	218,518	-	218,518	-
Income (loss) before income taxes	(1,604,934)	(909,234)	(2,514,168)	(992,350)
Provision for income taxes	-	-	-	-
Income (loss) for the period	(1,604,934)	(909,234)	(2,514,168)	(992,350)
Deficit, beginning of period	(9,132,877)	-	(9,132,877)	(8,140,527)
Adjustment for prior years' stock based compensation	(329,723)	-	(329,723)	-
Deficit, end of period	(11,067,534)	(909,234)	(11,976,768)	(9,132,877)
EBITDA	1,088,944	2,218,455	3,307,399	867,650
Normalized EBITDA	1,088,944	2,602,980	3,691,924	867,650

Peer 1 Network Enterprises, Inc. EBITDA Reconciliation Three Months Ended June 30 (unaudited - prepared by management)				
	Three Months Ended June 30, 2005 Peer 1	Three Months Ended June 30, 2005 ServerBeach (since Oct 20/04)	Three Months Ended June 30, 2005 Total	Three Months Ended June 30, 2004 Peer 1
Net Profit (Loss)	(716,203)	(145,587)	(861,790)	(244,914)
Interest Expense	309,627	629,648	939,275	510,923
Amortization - fixed assets and deferred network costs	416,286	284,496	700,782	221,355
Amortization - startup costs	(9,684)	-	(9,684)	-
Amortization - acquisition costs	-	(28,155)	(28,155)	-
Amortization - licence fees	-	310,849	310,849	-
Taxes	-	16,693	16,693	-
Stock-based compensation expense	13,345	-	13,345	-
Loss from equity accounted investment	218,518	-	218,518	-
Unrealized FX gains/losses	(69,041)	23,529	(45,512)	39,576
EBITDA	162,848	1,091,473	1,254,321	526,940
Integration Costs	-	38,078	38,078	-
Normalized EBITDA	162,848	1,129,551	1,292,399	526,940

Peer 1 Network Enterprises, Inc. EBITDA Reconciliation Year To Date (unaudited - prepared by management)				
	Year Ended June 30, 2005 Peer 1	Year Ended June 30, 2005 ServerBeach (since Oct 20/04)	Year Ended June 30, 2005 Total	Year Ended June 30, 2004 Peer 1
Net Profit (Loss)	(1,604,934)	(909,234)	(2,514,168)	(992,350)
Interest Expense	1,127,985	1,506,640	2,634,625	626,501
Amortization - fixed assets and deferred network costs	1,322,724	976,756	2,299,480	867,601
Amortization - startup costs	-	-	-	-
Amortization - acquisition costs	-	-	-	-
Amortization - licence fees	-	789,897	789,897	-
Taxes	7,714	38,301	46,015	-
Stock-based compensation expense	85,978	-	85,978	-
Loss from equity accounted investment	218,518	-	218,518	-
Unrealized FX gains/losses	(69,041)	(183,905)	(252,946)	39,576
EBITDA	1,088,944	2,218,455	3,307,399	541,328
Integration Costs	-	384,525	384,525	-
Normalized EBITDA	1,088,944	2,602,980	3,691,924	541,328

Overall Performance

Selected Measures of Financial Position And Operations	June 2005	June 2004	June 2003
Cash (including restricted cash)	\$970,538	\$976,848	\$650,907
Total Assets	\$24,153,916	\$9,517,460	\$6,494,277
Working Capital	\$-18,783,542	\$-1,188,031	\$-1,562,265
Long Term Financial Liabilities	\$119,228	\$3,319,312	\$3,235,074
Share Capital	\$11,245,992	\$9,914,432	\$6,779,922
Shareholders' Equity	\$340,918	\$1,437,548	\$-511,783
Total Revenue	\$24,113,348	\$13,587,914	\$9,934,024
Gross Margin	38.9%	36.5%	22.2%
Net Loss	\$2,514,168	\$992,350	\$3,281,335

Cash balances at the end of fiscal 2005 were essentially at the same level as at the end of fiscal 2004. Operating activities, before consideration of changes in working capital, generated approximately \$1.5 million during the year, with the net change in working capital items generating an additional \$3.1 million. The increase in accounts payable balances, combined with the classification of much of the company's debt as current, accounted for most of the reduction in working capital. The company was able to raise \$11.6 million in new financing during the year from a combination of debt (\$9.0 million), issuance of capital stock (\$1.3 million) and shareholder advances (\$1.2 million). The acquisition of ServerBeach (see below) and further investment in property and equipment for the network and data centres required the use of \$16.8 million of the cash generated from operations and financing activities.

Approximately \$0.6 million of the cash is unavailable for general use, as it is held as security for letters of credit required for operating purposes. This amount has been disclosed in the statements as "restricted cash". The restricted cash balance in 2004 was held for investment in the assets and working capital requirements of the Seattle data centre in accordance with the provisions of a long-term note. Those funds have all been expended for permitted purposes, with the result that there is no further restriction on any of the cash balances held.

On October 20, 2004, the company, through its 100% owned subsidiary, P1 Acquisition, Ltd. acquired all of the operating assets of San Antonio, Texas-based ServerBeach, Ltd. Included in the operating assets were existing customer contracts, an exclusive use licence for technology that is essential to the ServerBeach business and over 4,200 dedicated servers. The staff and management of ServerBeach were offered employment at P1 to operate the business with 85% accepting employment. As part of the purchase of assets, the company obtained rights to the company name and was granted the authority to rename P1 Acquisition, Ltd. to ServerBeach, Ltd. on October 22; the new company now operates under that name. The transaction was approved by the TSX Venture Exchange prior to the closing. The financial impact of this transaction is evident in the increase in total assets from the previous fiscal year end, and in debt levels, as noted below.

The company continues to invest in assets for the Peer 1 Network operating companies as well as for Server Beach. A new data centre was added in Herndon, Virginia to accommodate ServerBeach eastern USA operations as well as to serve Peer 1 colocation and bandwidth customers and further expansion took place in New York, Toronto and Seattle. This, as well as organic growth at Server Beach has resulted in additional fixed asset investment during the year.

During the third quarter of the fiscal year, the company reassessed the role it was playing in the operation of the VOIP (voice over internet protocol) company Symmetric Broadband Inc. that was started up as a joint venture between Peer 1 and another company in 2004. It was determined that the management effort required to continue to operate this company as a joint venture was not commensurate with the expected returns. Peer 1 no longer provides joint management over the operation, and is no longer committed to funding the operation equally with the other joint venturer. Peer 1's ownership of Symmetric has fallen to 28% at June 30, 2005 and as a result, the financial position and results of operation no longer include those of Symmetric Broadband on a proportionate consolidation basis – the investment is now accounted for as an equity investment. The net writedown during the year amounted to \$0.2 million.

The increase in long term financial liabilities is a result of the financing of the ServerBeach purchase price, which was US\$7.5 million. Peer 1 arranged bridge financing for the full purchase price from a company related to one of its Directors on commercially reasonable terms. The loan was due on June 30, 2005 with certain renewal provisions thereafter – the company exercised an option to extend the term of the loan for an additional six months for a fee of US\$400,000. The loan carried an interest rate of 6% per annum through December 31, 2004 and thereafter at 15% per annum. Interest payments were made monthly. During the third quarter, the loan agreement was amended to add US\$500,000 to the outstanding principal. This amount was identified in the original loan agreement as a transaction fee payable to the lender, and had been included in accounts payable. The US\$500,000 fee was amortized over an eight month period from November 2004 to June 2005, coincidental with the term of the loan. The \$400,000 extension fee will be amortized over the six months that the loan has been extended for.

The bridge loan is reflected on the financial statements as a current liability, in accordance with generally accepted accounting principles. Also included in current liabilities are the most of the notes issued as part of the 2003/2004 debt restructuring, since the term of these loans ends on June 30, 2006.

A major refinancing was completed subsequent to year end, and is discussed in the Subsequent Events section of this document.

Revenues for the year were 77% higher than for last year, which in turn was 37% higher than that for the preceding year. Of the current year's growth, the base operations of Peer 1 Network alone grew by over 25%, while the newly acquired ServerBeach accounted for the rest of the growth.

The overall gross margin has increased from 2004. For the colocation and bandwidth segment of the business, the margins were similar to those last year. It is the dedicated server segment, with its higher gross margins, that has resulted in the overall increase.

The increase in net loss this year is a result of reported losses on the newly acquired ServerBeach business, as well as increased Peer 1 losses. The Peer 1 increased loss reflects several factors: the company has recorded stock based compensation costs (in accordance with CICS Handbook section 3870) for this year; interest charges have increased; the Symmetric investment has been written down; costs associated with the new mergers & acquisitions function as well as employment severance.

RESULTS OF OPERATIONS

The colocation and bandwidth segment is the area of business that Peer 1 has historically provided services in. The ServerBeach acquisition has facilitated entry into the dedicated server segment.

Revenues

70% of the revenue this year was generated from colocation and bandwidth sales, with revenues from dedicated servers accounting for the balance. Since ServerBeach was acquired part way through the second quarter of the year, it is expected that the colocation and bandwidth portion of the business will account for a smaller proportion of total revenues in 2006..

Colocation and Bandwidth

Colocation revenues increased from \$4.5 million in 2004 to \$6.9 million in 2005 (54% growth). The increase is directly attributable to growth in the customer base - the number of colocation customers grew from 652 at the end of 2004 to 817 by the end of the 2005. This translated into a 38% increase in the number of units sold each month. The average selling price per customer has increased by about 14%, while the per-unit price has increased only slightly from 2004. This is a result of customers upgrading their colocation contracts.

Bandwidth revenues grew 6.5% from \$8.3 million in 2004 to \$8.8 million in 2005. Although the trend of falling bandwidth prices resulting from a highly competitive market continued this year, traffic has more than doubled, thereby offsetting the downward pressure on revenues. The ratio of colocation to bandwidth revenues is now 44%:56%, compared to 35%:65% in 2004.

In 2005, 81% of revenues earned were from the company's three Canadian sites, compared to 88% in 2004. Sales at the US locations continue to grow, with Seattle and New York recording the majority of the increase. Management expects that the US locations will continue their sales growth, as Peer 1 brand recognition increases.

The company continues to monitor capacity utilization closely, in order to ensure that anticipated growth is not adversely affected by a lack of available space. Space was added in Toronto and New York during the year, the two locations where capacity utilization has been higher than the company target. Additional space is also being considered in other US locations, including Los Angeles. It is intended that Peer 1 data centres be used for all segments of the company's business, with colocation and dedicated server customers in the same facility.

Dedicated Servers

The ServerBeach acquisition has made a positive contribution to the company's operating results, with over \$7.1 million in revenues earned from the October 20 2004 date of acquisition to year end. Revenues of ServerBeach, when compared on an annualized basis, have increased by approximately 52% since the date of acquisition. This has been a result of both an 20% increase in the volume of dedicated servers rented each month and an increase in the average revenue per server as customers have been renting higher value servers than in the past.

Gross Profit

The overall gross profit margin has increased from 36.5% in fiscal 2004 to 38.9% in fiscal 2005. This is because margins in the newly acquired dedicated server business have been higher than those for colocation and bandwidth.

Peer 1's gross margins have remained at essentially the same level as in fiscal 2004, as lower colocation margins resulting from a net increase in the total amount of data centre space have been offset by improved bandwidth margins. Colocation space has been added in Toronto, New York and Herndon, VA which has resulted in an increase in the cost of sales. As space is sold in these expanded facilities, each dollar of revenue earned improves the gross margin, since colocation costs are largely fixed and do not vary much with increased sales volumes. As traffic volumes on the network have increased, management has been successful in reducing the bandwidth cost per unit through restructured transport and transit contracts, with the resulting improvement in gross margin.

Operating Expenses

The largest component of operating expenses is salaries and wages which, year to date, comprise approximately 57% of the total (52% for the same period in fiscal 2004). The higher proportion is attributable to an increase in the number of sales people on staff (sales staff were added to the new US locations) as well as higher sales commissions that are a result of the increase in revenues. It is expected that this component will continue to increase relative to other operating expenses but decrease as a percentage of revenue as sales continue to increase.

Rent and administration costs make up the next most significant component at 27% of total operating costs largely unchanged from fiscal 2004. Management continues to focus on administration costs to ensure that operations are as efficient as possible. No major changes are anticipated for the costs in this category, relative to the other categories, though as Peer 1 grows its business these costs are expected to decline as a percentage of revenue.

Travel costs are 10% of total operating expenses, down from 12% in fiscal 2004. While it had been anticipated that travel costs would assume a greater significance given the addition of new sites and the POP in London, a portion of the travel that took place during the related to M&A projects; these costs are not part of operating expenses, as they have been capitalized in accordance with corporate accounting policy .

Professional fees account for 6% of total costs this quarter, down from 9% in fiscal 2004. While the magnitude of these costs will likely increase due to the growth of the company's operations through acquisitions, as a percentage of total operating expenses and revenue they are expected to decrease.

The Interland acquisition (see subsequent events section) will result in an increase in all of the operating cost categories in fiscal 2006, however total operating expenses as a percentage of revenue is expected to decrease.

SUMMARY OF QUARTERLY RESULTS

	Quarter Ended							
	September 30 2003	December 31 2003	March 31 2004	June 30 2004	September 30 2004	December 31 2004	March 31 2005	June 30 2005
Revenue	3,113,210	3,407,164	3,400,250	3,667,290	3,780,131	5,693,401	7,169,124	7,470,692
Operating Profit (Loss)	(196,463)	66,585	156,654	(64,459)	(57,966)	51,591	669,173	522,577
Net Income (Loss)	(504,767)	(248,638)	5,969	(244,914)	(311,669)	(178,709)	(1,162,000)	(861,790)
Pro forma basic and fully diluted income (loss) per share	(0.01)	(0.01)	0.00	(0.01)	(0.01)	(0.00)	(0.03)	(0.02)
EBITDA	44,078	277,177	421,865	124,530	213,285	653,734	1,532,506	1,292,399

LIQUIDITY AND CAPITAL RESOURCES

As of year end, the company had a cash and cash equivalents balance of just under \$1.0 million. As noted previously, this includes \$0.6 million of restricted funds which have been set aside as security for letters of credit.

The company had a working capital deficit of \$18.8 million at the end of the year. Included in this amount is the current portion of long term debt, as well as short term shareholder notes and the accrued interest thereon. If these items are excluded from the calculation, on the assumption that shareholders would be unlikely to impact liquidity in a negative manner (most of the long term debt is held by related parties), the working capital deficit is reduced to \$2.6 million.

On September 2, 2005 the company secured additional financing and reorganized certain existing debts, as a result of which the company's working capital deficit has been eliminated and the company's liquidity is sufficient to fund existing operations for the foreseeable future. Details of the refinancing are provided in the Subsequent Events section.

Operating Activities

Operating activities, prior to consideration of the change in working capital balances, generated substantially more cash than last year (2005 - \$1.5 million, 2004 - \$0.2 million). This is primarily because the increase in revenues was greater than the commensurate increase in cash based expenses. Future revenue growth is also expected to follow this trend, with the result that cash flows are anticipated to continue from operations in the coming year.

Investing Activities

Investing activities during the year reflect the ongoing capital investment required in a rapidly growing business, as well as the acquisition of ServerBeach. Continued investment in equipment and facilities for the colocation and bandwidth segment of the business, and for equipment for the dedicated server segment will be required in the next fiscal year.

Financing Activities

The company financed its activities during the year by way of debt, share issues and shareholder advances. In management's opinion, the additional funds provided by the refinancing agreement will meet the company's cash flow requirements for fiscal 2006.

OFF-BALANCE SHEET ARRANGEMENTS

The company has provided three letters of credit totaling US\$500,000 as security to a landlord for a facility lease and for two major suppliers. The security for the facility lease will be required for the term of the lease, whereas the security for the suppliers is dependant on whether the company continues to use the same suppliers, the extent to which a sufficient credit history is built up with the suppliers to reduce or negate the need for such security, and other similar discretionary factors. The letters of credit are secured by way of term deposits which are included in the reported cash balance. The year end financial statements classify the term deposits as restricted cash.

TRANSACTIONS WITH RELATED PARTIES

During the year Peer 1 provided services in the normal course of business to companies either owned or subject to significant influence by the company's directors and principal shareholders.

At the end of the year, amounts due to and from related parties were as follows:

	2005	2004
Included in accounts receivable	\$61,054	\$264,767
Included in accounts payable and accrued liabilities	\$4,498	2,996

During the period, transactions with related parties were as follows:

	2005	2004
Revenues earned	\$109,236	\$360,627
Interest expensed	\$1,506,225	\$876,676
Other expenses incurred	\$74,801	-

These transactions are in the normal course of operations and are measured at their exchange amounts. Included in other expenses incurred is \$70,000 in accounts receivable from related parties that was written off.

FOURTH QUARTER RESULTS

Total revenues for the fourth quarter were 4% higher than for the third quarter. The colocation and bandwidth segment of the business remained at the same level as the third quarter, while the dedicated server segment component grew by over 10%. The revenue mix for the fourth quarter was 61% colocation and bandwidth, 39% dedicated servers. This compares with a 63% to 37% mix in the previous quarter.

Gross margin in the fourth quarter was 40.1%, up from 39.2% in the third quarter. Dedicated server margins are higher than those for the colocation and bandwidth segments, with the result that the overall profit margins increase as the proportion of dedicated server revenue increases.

Fourth quarter operating expenses are approximately \$0.3 million higher than in the third quarter (after restating the third quarter results to conform to the presentation used in the annual report). Bad debt expenses, as well as higher salaries and travel costs account for the increase.

SUBSEQUENT EVENTS

Liquidity concerns and the need to increase the capitalization of the company have been areas that management has spent significant time and effort on. Subsequent to the year end, a refinancing of the company was completed. This process involved several steps, as outlined below:

- Extension of the maturity date of the loan that was used to finance the ServerBeach acquisition. The company exercised a six month renewal option, and extended the maturity of the US\$7,500,000 bridge loan to December 31, 2005. The transaction fee associated with the renewal is US\$400,000, which was satisfied by issuing 1,538,625 shares at a price of \$0.32 per share. On September 2, 2005, this loan was repaid from the proceeds of the loan from Fortress Credit Corp. described below.
- On July 18, 2005 the Company closed a US\$2.0 million loan with companies controlled by directors. On September 2, 2005, this loan was repaid from the proceeds of the loan from Fortress Credit Corp. described below.
- In connection with the Interland acquisition described below, the company completed on September 2, 2005 a US\$35 million loan agreement with Fortress Credit Corp., of which US\$24 million has been advanced. The loan agreement (the "LSA") is by and among Peer 1 (USA), Inc. and each of its subsidiaries that are signatories thereto as borrowers (the "Borrowers"), the company and each of its subsidiaries that are signatories thereto as guarantors (the "Guarantors"), and Fortress Credit Corp. ("Fortress") as the lender, arranger and administrative agent.

Pursuant to the LSA, Fortress agreed to make three loan facilities available to the Borrowers: a term loan which was advanced on September 2, 2005 in the amount of US\$24 million; a term loan (the "Incremental Term Loan") of up to US\$4 million (less if certain cash flow criteria specified in the LSA are not satisfied) and a revolving loan (the "Revolving Facility") of up to US\$7 million until September 2, 2008 and US\$10 million thereafter until September 2, 2010 if the maturity date is extended by the Company for two years in accordance with the terms of the LSA.

The obligation of the Lender to make the Incremental Term Loan is subject to certain conditions precedents which have not yet been satisfied, including the provision of additional security for the obligations of the Borrowers under the LSA

and a requirement that the request for such loan is made on or before November 22, 2005.

The obligation of the lender to make the Revolving Facility is subject to certain conditions, including that no advance shall be made:

- (a) that would result in the aggregate borrowings under the LSA exceeding US\$24 million, such limit to increase to US\$28 million after the Incremental Term Loan is advanced;
- (b) if the aggregate amount advanced under the Revolving Facility in any 12 month period would exceed an amount determined with reference to the aggregate purchase price of certain equipment purchased by the Borrowers during such 12 month period; or
- (c) if the aggregate advances under the Revolving Facility during any 12 month period exceeds US\$2.5 million.

The interest rate on borrowings under the LSA is LIBOR plus 6.5% per annum, subject to adjustment in certain specified circumstances. The borrowings must be repaid in installments, commencing on October 1, 2005. A portion of the net proceeds received by any of the Borrowers from the sale of assets or the issuance of equity securities must be used to prepay the loan. The maturity date of the loan is September 1, 2008, though the Company may extend the maturity date for two years by giving notice of such extension at least 90 days before September 1, 2008.

In connection with the LSA, the company issued warrants entitling the holders to acquire 2,306,571 common shares at a price per share of US\$0.23 for a period of 5 years.

- The company and its subsidiary, Peer 1 Network (USA) Inc. ("Peer 1 USA"), have entered into a Series A Preferred Stock Purchase Agreement (the "SPA") dated September 2, 2005 with several investors (the "Investors") pursuant to which Peer 1 USA issued on September 2, 2005 7,000 shares of Series A Preferred stock in its capital at a price per share of US\$1,000, for aggregate proceeds of US\$7,000,000.

The Series A Preferred stock carries one vote per share and a cumulative annual dividend of 8%. In the event of any liquidation, dissolution or winding up of Peer 1 (USA), the holders of the Series A Preferred stock are entitled to receive, in preference to any distribution of the assets of Peer 1 (USA), an amount per share equal to the Liquidation Value for each share of Series A Preferred stock. The Liquidation Value of a share of Series A Preferred stock is:

- (a) for the period beginning on September 2, 2005 (the "Closing Date") through but excluding the second anniversary of the Closing Date, US\$1,000 per share,
- (b) for the period beginning on such second anniversary through but excluding the third anniversary of the Closing Date, US\$1500 per share and
- (c) for the period beginning on the third anniversary of the Closing Date and thereafter, US\$2000, subject in each case to adjustments in certain circumstances.

At any time after the fourth anniversary of the Closing Date and provided that the amounts borrowed under the LSA have been repaid and the LSA has been terminated, any holder of shares of Series A Preferred stock may cause Peer 1 (USA) to redeem any or all of its outstanding shares of Series A Preferred stock at a price per share of US\$2000.

In connection with the SPA, the company and Peer 1 (USA) entered into an Investors' Rights Agreement (the "IRA") dated as of September 2, 2005 with the Investors. In addition to providing the Investors with rights to register their shares of Series A Preferred stock in the United States in certain circumstances, the IRA contains rights of put and call as follows:

- (a) Any Investor may require the Company to purchase for US\$2,000 per share any or all of its shares of Series A Preferred stock at any time after the fourth anniversary of the Closing Date, upon a liquidation, dissolution or winding up of the Company or upon a change of control.
- (b) At any time after the fourth anniversary of the Closing Date, the Company may require the Investors to sell all of their shares of Series A Preferred stock to the Company at a price per share of US\$2000.
- (c) Any investor may at any time require the Company to purchase any or all of its shares of Series A Preferred stock in exchange for the number of common shares in the capital of the Company determined by dividing \$1,000 per share of Series A Preferred stock being exchanged by US\$0.2291, subject to adjustment in certain specified circumstances.

Pursuant to the IRA, the company has granted to each Investor a right of first offer with respect to future sales by the company of any of its shares or securities convertible into or exchangeable or exercisable for any shares in the capital of the company.

The company, Peer 1 (USA), the Investors and certain shareholders of the company have entered into a Shareholder Agreement dated September 2, 2005 (the "Shareholder Agreement"). Pursuant to the Shareholder Agreement, the company has agreed to seek shareholder approval to increase its authorized share capital and cause its management to take all necessary actions so that a nominee of Celerity Partners SBIC, L.P. is a member of the Board of Directors of the company.

Celerity Partners SBIC, L.P., of Menlo Park, California, acquired US\$4,090,000 and insiders of the company acquired US\$2,660,000 of the Series A Preferred stock.

- The company has converted approximately \$7,013,698.25 of its aggregate indebtedness into 25,274,588 common shares of the company, at a price per share of \$0.2775.
- The company, through a wholly owned subsidiary, entered into an asset purchase agreement dated August 31, 2005 with Interland, Inc. ("Interland"). Pursuant to the agreement, Interland has agreed to sell, and the company has agreed to purchase, all of the assets of Interland that are necessary for the daily

operation of Interland's dedicated server business. The company has also agreed to assume certain liabilities of Interland. In addition, Interland has granted to the company a royalty-free non-exclusive license to the intellectual property owned by Interland and access to property licensed by Interland from third parties. The purchase price for the assets and the obligations of Interland is US\$14,000,000, subject to adjustment in accordance with the asset purchase agreement. 20% of the purchase price prior to adjustment was placed in escrow as security for the obligations of Interland under the agreement. Peer 1 and Interland have also entered into an administrative services agreement dated as of August 31, 2005. As a result of the transaction, Interland becomes a significant co-location, bandwidth and managed services customer of the company.

OUTSTANDING SHARE DATA

Peer 1 has authorized share capital of 100,000,000 common shares without par value. At June 30, 2005 49,119,367 common shares were issued and outstanding (44,365,367 as at June 30, 2004). A further 26,818,213 common shares have been issued as of the date of this MD&A, bringing the total number of common shares issued and outstanding to 75,937,580.

2,334,215 warrants for the purchase of shares ranging in price from \$0.28 to \$0.32 were outstanding at year end (2004 – 16,323,880). 5,406,571 additional warrants were issued subsequent to year end entitling the holders to purchase shares at prices ranging from \$0.28 to \$0.40.

3,647,250 (2004 – 3,428,250) stock options were outstanding at year end under the company's stock option plan. 5,000 options were exercised after year end; no additional options have been issued as of the date of this MD&A, though a total of 122,500 options have been presented to the Board for approval. If approved, the options would be issued for prices ranging from \$0.36 to \$0.45.

Under the preferred share financing described in the previous section, 7,000 preferred shares of Peer 1 Network (USA) Inc. were issued. By way of the Investor Rights Agreement, the holders of the preferred shares may require the company to acquire any or all of their preferred shares in exchange for common shares of Peer 1. Subject to adjustment in specified circumstances, the conversion would be for 4,365 common shares of Peer 1 for each preferred share.

CRITICAL ACCOUNTING ESTIMATES

Management makes certain estimates in order to report the company's financial position and results of operations. Such estimates include the collectability of accounts receivable, the useful life of fixed assets, the likelihood of M&A projects being completed (see section below), valuation of the conversion features attached to debt instruments and warrants issued.

In estimating the allowance for doubtful accounts, management reviews the payment history of current customer as well as overall historical collection trends. Our allowance is in the range of 2-2.5% of annual revenues.

Estimates as to the useful life of fixed assets are based upon experience and are in line with other companies in the industry.

The likelihood of M&A projects being completed are based on the facts involved in each particular case.

Valuation of the debt conversion features and issue of warrants is based on estimates of dividend yield (Nil), expected volatility of the Peer 1 stock price (75%), risk-free interest rate (estimate changes over time as actual results change) and option term (varies depending on the warrants or options issued).

In all of the above cases, actual results may be different than the estimates made.

ACCOUNTING POLICIES

The company prepares its financial statements on the basis of accounting principals generally acceptable in Canada. All accounting policies have been applied on a basis consistent with that of the previous year.

During the year, as part of its growth strategy, the company undertook a process of identifying and pursuing organizations for potential acquisition. As a result, costs directly related to acquisitions continue to be incurred. The company has adopted a policy of deferring such costs for proposed transactions where completion is considered to be more likely than not. These deferred costs will be added to the cost of purchase upon completion. Should the status of a project change to become unlikely to complete, the costs associated with that project are expensed. As of the end of year, \$352,000 of costs had been deferred (2004 - \$163,000).

The annual results include the cost of stock based compensation, in accordance with generally accepted accounting principles. The company has chosen to apply the accounting treatment retroactively, without restatement of prior years' balances. Accordingly, a \$329,723 adjustment to opening retained earnings has been made, representing the costs applicable to prior years, and a further \$86,000 has been charged to income in the current year. If the prior year amounts had been restated, the impact on 2003 would have been \$72,799 and that on 2004 \$256,924.

Non-GAAP Measures

The company reports Earnings Before Interest, Taxes, Depreciation and Amortization ("EBITDA"), which is an approximate measure of operating cash flow based on financial data from the company's income statement. EBITDA is not a recognized accounting measure nor is it defined by generally accepted accounting principles. This non-GAAP measure may not be an identical presentation when compared with other company reports, as the nature of amounts included in amortization varies. The disclosure of EBITDA is strictly presented for informational purposes and is not intended to replace financial results presented from operations or cash flow.

An EBITDA reconciliation is included in a previous section so that the components are clearly disclosed. It should be noted that the measure has been amended to reflect the impact of unrealized foreign exchange gains and losses. The EBITDA numbers in the quarterly information trend section have been amended accordingly.

OUTLOOK AND RISKS

Outlook

The demand for high-speed, IP-based network services is growing rapidly, as both businesses and individual users place greater reliance on web-based information and applications. As a result, the industry segment that Peer 1 operates in is expected to continue along an upward growth trend as the demand for the outsourcing of secure internet infrastructure also grows.

Revenues are expected to continue their growth trend, though the growth rate is likely to fall because of the larger base. Recent results have been impacted by declining internet bandwidth pricing. It is expected that prices will stabilize during 2006, as a result of increased demand.

Risks

The company is subject to a number of business risks inherent in the industry, including competitive pressures, credit risk, foreign exchange risk and technological change.

Peer 1 operates in a competitive market. The company has attempted to differentiate itself from the competition by the high level of customer service we provide and the quality of the products we offer. Management intends to keep Peer 1's product offerings focused, so as to continue to deliver the high level of quality at a competitive price.

The company's bad debt rate has been reduced to 2-2.5% in the most recent fiscal year as a result of more sophisticated credit and collections procedures. This, together with the company's high retention rate of customers mitigates credit risk.

The company currently operates in Canada and the USA, and has recently established a POP in the UK, and is thereby subject to risks typical of an international business including, but not limited to, differing economic conditions, differing tax structures, other regulations and restrictions and foreign exchange rate volatility. The company has evaluated its exposure to these risks, and has determined that its only significant exposure is to exchange rate risk with respect to the US dollar. At this time, costs denominated in US dollars (including debt servicing costs) exceed US denominated revenues. The company does not engage in hedging transactions, but anticipates that revenue growth in Peer 1's US locations, together with ServerBeach operations, will offset the exchange rate risk to a greater extent in 2006.

Technology is evolving rapidly, with the result that a major shift in communications technology away from the current IP based system could have a significant impact on all companies in the industry.

OTHER INFORMATION

Additional information relating to the company is available on SEDAR at www.sedar.com.