

peer1

NETWORK | CO-LOCATION | DEDICATED HOSTING



THREE AND SIX MONTHS ENDED DECEMBER 31, 2007 AND 2006  
**MANAGEMENT'S DISCUSSION & ANALYSIS**

**MANAGEMENT'S DISCUSSION AND ANALYSIS  
OF INTERIM FINANCIAL RESULTS  
FOR THE THREE AND SIX MONTHS ENDED DECEMBER 31, 2007**

*This Management Discussion and Analysis ("MD&A"), dated February 8, 2008, should be read in conjunction with Peer 1's unaudited first quarter financial statements, as well as the audited annual financial statements for the fiscal year ended June 30, 2007 and the notes thereto, all of which can be found on [www.sedar.com](http://www.sedar.com). Unless otherwise noted, all figures noted are in United States dollars.*

**FORWARD LOOKING STATEMENTS**

This MD&A includes forward-looking statements. Forward-looking statements are statements that are not historical facts and are generally, but not always, identified by the use of forward-looking terminology such as "expects", "plans", "anticipates", "believes", "intends", "estimates", "projects", "potential" and similar expressions, or that events or conditions "will", "would", "may", "could" or "should" occur, or the negatives of these terms or variations of them or similar terminology. By their nature, forward-looking statements require Peer 1 to make assumptions and are subject to important known and unknown risks and uncertainties, which may cause Peer 1's actual realities in future periods to differ materially from forecasted realities. While Peer 1 considers its assumptions to be reasonable and appropriate based on current information available, there is a risk that they may not be accurate.

Certain factors that could cause actual realities to differ materially from those anticipated in the forward-looking statements include risks associated with general economic conditions and Peer 1's business environment, operational risks and financing risks. Readers are cautioned that the foregoing list of factors that may affect future growth and realities is not exhaustive and undue reliance should not be placed on forward-looking statements. The forward-looking statements set forth herein reflect Peer 1's expectations as at the date of this MD&A and are subject to change after such date. Unless otherwise required by applicable securities laws, Peer 1 expressly disclaims any intention and assumes no obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

**OVERVIEW**

**Quarterly Financial Highlights**

- Peer 1's revenue increased 23.02% to \$22.22 million for the three months ended December 31, 2007, compared to \$18.07 million for the three months ended December 31, 2006.
- Gross profit increased 44.08% to \$10.13 million for the three months ended December 31, 2007, compared to \$7.03 million for the three months ended December 31, 2006.
- Operating income increased 76.32% to \$3.91 million for the three months ended December 31, 2007, compared to \$2.22 million for the three months ended December 31, 2006.
- Income before income taxes was \$3.27 million for the three months ended December 31, 2007 compared to \$0.68 million for the three months ended December 31, 2006.

- Net income was \$1.88 million for the three months ended December 31, 2007, compared to \$0.85 million for the three months ended December 31, 2006.

### **Quarterly Key Developments**

- On October 3, 2007, Peer 1 began offering the latest SWsoft Plesk 8.2 for Linux control panel software for its managed hosting customers. Plesk provides server administrators with a tool to manage their servers and websites and includes an intuitive interface that allows users without a technical background to create new email accounts and manage domains. The Plesk control panel automates a large number of tasks to help service providers reduce operating costs and resources.
- On November 28, 2007, Peer 1 initiated SaaS3, a Software-as-a-Service (SaaS) incubation and enablement service, for Independent Software Vendor (ISV) partners. SaaS3 assists small to mid-sized ISVs test, deploy and manage web 2.0, enterprise 2.0 and SaaS applications throughout the entire product lifecycle on the Microsoft Windows platform. The program builds on Peer 1's existing infrastructure for SaaS applications, and walks businesses through the essential aspects of building and deploying applications running on the Microsoft platform. ISVs can begin by working on products from the ground up in an online developer sandbox. Then when the product is ready for market, it can be seamlessly transitioned online, within the Peer 1 secure, managed hosting infrastructure. These services can help reduce the ISVs' IT spending and consolidate resources needed for SaaS applications. As the product and company grows, the SaaS3 program provides expert consultation and a fully scalable network to support it.
- On December 11, 2007, Peer 1 launched its "We get IT" marketing campaign which focuses on the people behind technology, sharing customer stories and playing on web hosting and technology issues in a humorous manner. Peer 1 is using traditional marketing mediums in addition to popular social media tools, such as viral video pieces, to reach business and technology operators in all fields. Peer 1's viral marketing includes "Growing Pains," a humorous video short series telling the story of a home business start-up that quickly grows out of control and overtakes the house with new employees, computers and servers. Video customer stories featuring leading VoIP provider Vonage, free online dating site PlentyofFish.com, and interactive design agency Blast Radius are currently featured on Peer 1's web site.
- During the quarter ended December 31, 2007, the Company continued its implementation of its substantial upgrade of the Peer 1 IP network. This upgrade includes the installation of carrier class routers purchased from the leaders in high performance networking, Cisco and Juniper. These two suppliers were chosen as part of the Peer 1 multi-vendor strategy to leverage the capabilities of each supplier to provide a best fit to each area of the Peer 1 backbone. The Juniper M series multiservice edge routing portfolio uniquely combines best-in-class IP/MPLS capabilities with reliability, stability, security, and service richness, while the Cisco 7600 series provides the same features with the added benefit of having high-density Ethernet switching capabilities. Each router series has 10 gigabit interface capabilities allowing Peer 1 to upgrade existing areas of the backbone, as well as keeping an eye to the future for further capacity expansion. As a result of this purchase the Company will have substantially increased bandwidth capacity, IP performance and the ability to accommodate new feature sets such as MPLS. The total estimated capital expenditure related to this upgrade is approximately \$4 million.

## **OUR BUSINESS**

Peer 1 is a provider of Internet infrastructure solutions and related managed services. Peer 1's service offerings include bandwidth, co-location, and dedicated hosting services. The Company's customers are primarily a broad cross section of small and medium-sized businesses across North America including community based hosting providers, online video gaming companies and Internet phone (VoIP) companies. Peer 1 has established data centers and points of presence ("POPs") in 17 cities across North America and Europe including: Vancouver, Toronto, Montreal, New York, Seattle, San Jose, San Antonio, Los Angeles, Miami, Atlanta, Fremont, Herndon, Ashburn, Chicago, Dallas, Amsterdam and London, England.

Increased dependency on the Internet by business, technology enthusiasts and community based networks is driving the need for more Internet infrastructure solutions. Increased complexity of IT infrastructure is driving the need for outsourced service providers such as Peer 1. Management of Peer 1 believes that the Company has been successful in attracting and generating business as a result of offering:

- Cost savings
- 24 hours, 7 days a week monitoring
- Environmentally protected facilities
- High level of security
- Access to a high bandwidth, high quality IP network
- Customer support
- Scalability
- Backup and redundancy capabilities

### **Dedicated Hosting**

Peer 1 provides competitively priced, managed and self managed dedicated server solutions to small- and mid-size businesses. Managed dedicated hosting is a comprehensive web hosting solution where a client leases a Peer 1 server housed in one of the Company's data centers, and receives professional managed support. The server is dedicated to the customer's use only. Self-managed dedicated hosting is similar, but the customer performs the majority of management activities on the server

### **Co-location**

Peer 1's co-location service involves the physical locating of a customer's switching gear and/or servers in one of the Company's data center facilities that provide the infrastructure necessary for effective functioning of their equipment. The infrastructure resources include a secured cage or cabinet, regulated power, emergency backup power, dedicated Internet connection, regulated air temperature and physical security. Co-location customers are charged for the service provided by way of a monthly charge.

### **Bandwidth (Network)**

Peer 1's bandwidth service is provided by way of an expandable network through connections to multiple globally based providers in Canada, the US, the UK and the Netherlands. Peer 1 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.

## **STRATEGY**

Peer 1's growth strategy includes organic, leveraged, and accelerated growth. Organic growth focuses on the addition of new customers and the expansion of the network's reach into key peering points worldwide. Leveraged growth focuses on the introduction of new products and services that leverage and complement Peer 1's current infrastructure. Accelerated growth is based on pursuing investments and acquisitions complementary to existing lines of business.

### **Dedicated Servers**

Peer 1's strategy for dedicated servers is to provide Internet infrastructure built with quality parts and related services within a low cost framework that supports a value priced full customer solution. The Company specializes in offering both self-managed dedicated hosting where the client retains control of the functionality and performance of the server and in managed dedicated hosting where Peer 1 provides a range of managed services including providing firewalls, storage area network, security and support to augment the client's applications.

### **Bandwidth (Network)**

Peer 1's strategy is to continue to build a series of dedicated links, peering relationships and establish traffic exchange agreements with other networks using multiple high-speed connections. Peering arrangements are fundamental to the Company's strategy, and create two advantages: first, they reduce latency between networks; and second, they avoid additional costs associated with a third party network. 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.

### **Co-location Facilities**

On an ongoing basis Peer 1 looks for expansion opportunities in current markets that have shown strong demand as well as new geographic markets that present a positive market profile. When a market is considered viable, the Company identifies suitable space for long term lease. Wherever possible, sites that have previously been operated as data centers are sought to reduce initial capital investment requirements. Equipment is acquired and installed on a phased basis based on demand. As market share grows, additional space and equipment are acquired.

## RESULTS OF OPERATIONS

The table below presents, for the periods indicated, the statement of operations.

Peer 1 Network Enterprises, Inc. Consolidated Income Statement Three and Six Months Ended December 31 (unaudited - prepared by management) (in thousands of United States Dollars, except per share amounts)				
	Three Months Ended December 2007 US\$	Three Months Ended December 2006 US\$	Six Months Ended December 2007 US\$	Six Months Ended December 2006 US\$
Revenue	22,224	18,065	43,183	35,515
Cost of Sales	12,099	11,037	24,082	21,964
Gross Profit	10,125	7,028	19,101	13,551
Operating expenses	6,216	4,811	12,367	9,598
Operating Income before other items	3,909	2,217	6,734	3,953
Other Items:				
Interest Income	(108)	(81)	(226)	(147)
Amortization of preferred share discount	-	374	-	731
Interest expense - long term	564	851	1,160	1,707
Interest accretion on notes payable	22	54	44	110
Integration costs	-	293	93	518
Foreign exchange loss (gain)	157	(5)	256	(38)
Loss (Gain) on disposal of fixed assets	7	51	(7)	46
Income before income taxes	3,267	680	5,414	1,026
Future income tax expense (recovery)	663	(625)	990	(625)
Current Income tax expense	722	456	1,296	553
Income tax expense (recovery)	1,385	(169)	2,286	(72)
Net income and comprehensive income	1,882	849	3,128	1,098
Deficit, beginning of period	(6,831)	(11,459)	(8,077)	(11,708)
Deficit, end of period	(4,949)	(10,610)	(4,949)	(10,610)
Basic and diluted earnings per share	0.02	0.01	0.03	0.01

### Revenues

The Company's business model is based on recurring revenue streams for all of its main offerings. Customer revenue from services and product offerings, which are invoiced monthly, generally continue on a go forward basis with a manageable level of customer churn. Customer contracts range from month-to-month to three year terms.

Services revenue includes additional charges for power and setup fees for initial configuration and installation of services. Setup fees are typically billed once and only upon completion of such configuration and installation.

	Three months ended December 31				Six Months ended December 31			
	2007	%	2006	%	2007	%	2006	%
Revenue:								
Colocation	3,254,097	15%	2,421,727	13%	7,367,241	17%	4,707,953	13%
Bandwidth	2,540,191	12%	1,982,867	12%	4,872,077	12%	4,162,595	12%
Services	1,211,588	4%	697,461	4%	1,092,869	3%	1,228,940	3%
Dedicated Servers	15,218,150	68%	12,962,991	72%	29,851,018	69%	25,415,808	72%
<b>Total Revenue</b>	<b>\$ 22,224,026</b>	<b>100%</b>	<b>\$ 18,065,046</b>	<b>100%</b>	<b>\$ 43,183,206</b>	<b>100%</b>	<b>\$ 35,515,296</b>	<b>100%</b>

Consolidated revenue increased to \$22.22 million for the three months ended December 31, 2007 from \$18.07 million for the three months ended December 31, 2006. Consolidated revenue increased to \$43.18 million for the six months ended December 31, 2007 from \$35.52 million for the six months ended December 31, 2006. The increase in revenue is attributable to organic growth, leveraged growth and the effect of the appreciation of the Canadian dollar against the US dollar. The increase in revenue for the three months ended December 31, 2007 compared to the three months ended December 31, 2006 as a result of the increased value of Canadian dollar denominated sales totaled \$0.82 million and was \$0.39 million, \$0.32 million and \$0.11 million for Colocation, Bandwidth and Services revenue respectively. The increase in revenue for the six months ended December 31, 2007 compared to the six months ended December 31, 2006 as a result of the increased value of the Canadian dollar denominated sales totaled \$1.18 million and was \$0.56 million, \$0.47 million and \$0.16 million for Colocation, Bandwidth and Services revenue respectively.

Co-location revenues increased to \$3.25 million in the three months ended December 31, 2007 from \$2.42 million for the three months ended December 31, 2006. Co-location revenues increased to \$7.37 million for the six months ended December 31, 2007 from \$4.71 million for the six months ended December 31, 2006. The increase is attributable to increased pricing, increased sales volume and appreciation of the Canadian dollar against the US dollar.

Bandwidth revenues increased to \$2.54 million for the three months ended December 31, 2007 compared to \$1.98 million for the three months ended December 31, 2006. Bandwidth revenues increased to \$4.87 million for the six months ended December 31, 2007 compared to \$4.16 million for the six months ended December 31, 2006.

Dedicated server revenues increased to \$15.22 million for the three months ended December 31, 2007 from \$12.96 million for the three months ended December 31, 2006. Dedicated server revenues increased to \$29.85 million in the six months ended December 31, 2007 from \$25.42 million for the six months ended December 31, 2006. The increase for the three and six month period ended December 31, 2007 is attributable to increased sales, addition of new customers, an overall decrease in customer churn rates.

The Company's Canadian operations accounted for \$5.16 million of revenues in the three month period ended December 31, 2007 compared to \$3.83 million of revenues in the three months ended December 31, 2006. The Company's Canadian operations accounted for \$9.75 million of revenues in the six month period ended December 31, 2007 compared to \$7.55 million of revenues in the six months ended December 31, 2006. This change is the result of increased co-location revenues in the Canadian operations for the three and six months ended December 31, 2007 compared to the same periods last year.

Revenue for the comparative periods has been presented in accordance with the presentation in the current period and reflects a reclassification from revenue to interest income of \$0.07 million and \$0.1 million for the three and six months ended December 31, 2006 respectively.

## Cost of Sales

Cost of sales for the Company is primarily fixed and relates to infrastructure and staffing. Infrastructure costs consist of rent, maintenance, power, cooling, security, leasing and/or amortization of equipment and improvements, insurance, software licenses and supplies. Variable costs consist of power consumption, and incremental bandwidth from upstream carriers.

Consolidated cost of sales increased to \$12.1 million for the three months ended December 31, 2007 from \$11.04 million for the three months ended December 31, 2006. Cost of sales as a percentage of revenue decreased to 54% in the quarter ended December 31, 2007 from 61% for the quarter ended December 31, 2006. Consolidated cost of sales increased to \$24.08 million for the six months ended December 31, 2007 from \$21.96 million for the six months ended December 31, 2006. Cost of sales as a percentage of revenue decreased to 56% in the six months ended December 31, 2007 from 62% for the six months ended December 31, 2006. The decrease in cost of sales as a percentage of revenue is attributable to the reduction in depreciation on certain fully depreciated equipment acquired in September 2005 in addition to reductions in the cost of bandwidth. Revenue increased 23% for the three months ended December 31, 2007, compared to the three months ended December 31, 2006 while cost of sales increased 10% in the same period. Revenue increased 22% for the six months ended December 31, 2007, compared to the six months ended December 31, 2006 while cost of sales increased 10% in the same period.

In the three months ended December 31, 2007, in order to better reflect their functional contribution to the Company, \$0.2 million in costs associated with certain technical staff were included in operating expenses, specifically technology and customer relations. Comparative cost of sales figures for the three months ended December 31, 2006 reflect a reclassification of \$0.3 million from cost of sales to operating expenses. For the six months ended December 31, 2007, cost of \$0.5 million was included in operating expenses, specifically technology and customer relations. Comparative cost of sales figures for the six months ended December 31, 2006 reflect a reclassification of \$0.7 million from cost of sales to operating expenses.

Total cost of sales is expected to increase as revenues increase. The pattern of growth in revenues does not generally match the pattern of growth in the related costs due to the relatively large fixed cost component of the operating infrastructure. The cost of sales related to co-location is primarily affected by the cost of facilities. The cost of sales related to bandwidth is primarily affected by cost for bandwidth, transport and infrastructure. The cost of sales related to the dedicated server line of business is primarily affected by the costs of facilities, costs of servers and bandwidth costs.

## Operating Expenses

The following table presents operating expenses consisting of sales and marketing, general and administrative and technology and customer relations, as a percentage of revenue.

	Three months ended December 31				Six Months ended December 31			
	2007	%	2006	%	2007	%	2006	%
Total Operating Expenses	\$ 6,215,384	28%	\$ 4,810,016	27%	\$ 12,366,697	29%	\$ 9,597,349	27%

Total operating expenses increased to \$6.22 million for the three months ended December 31, 2007 from \$4.81 million for the three months ended December 31, 2006. Operating expenses as a percentage of revenue increased to 28% for the three months ended December 31, 2007 from 27% for the three months ended December 31, 2006. Total operating expenses increased to \$12.37 million for the six months ended December 31, 2007 from \$9.6 million for the six months ended December 31, 2006. Operating expenses as a percentage of revenue increased to 29% in the six months ended December 31, 2007 from 27% for the six months ended December 31, 2006.

As well, as discussed in cost of sales above, in the three months ended December 31, 2007, in order to better reflect their functional contribution to the Company, \$0.2 million in costs associated with certain technical staff were included in operating expenses, specifically technology and customer relations. Comparative operating expense figures for the three months ended December 31, 2006 reflect a reclassification of \$0.3 million from cost of sales to operating expenses. For the six months ended December 31, 2007, \$0.5 million in costs associated with certain technical staff were included in operating expenses, specifically technology and customer relations. Comparative operating expense figures for the six months ended December 31, 2006 reflect a reclassification of \$0.7 million from cost of sales to operating expenses.

General and administrative expenses accounted for 57% and 60% of total Operating Expenses for the three and six months ended December 31, 2007 respectively compared to 60% and 60% for the three and six months ended December 31, 2006 respectively.

Sales and marketing expenses accounted for 35% and 31% of total Operating Expenses for the three and six months ended December 31, 2007 respectively compared to 25% and 25% for the three and six months ended December 31, 2006 respectively. The increase in sales and marketing expenses as a percentage of operating expenses for the three and six months ended December 31, 2007 compared to the same period last year is attributable to higher marketing and staffing costs related to Peer 1's marketing initiatives to support organic growth and leveraged growth.

As the Company continues to pursue its growth strategy, operating expenses may increase to support marketing, promotional opportunities and general and administration requirements.

#### **Other income and expenses:**

Interest income for the three and six months ended December 31, 2007 was \$0.1 million and \$0.2 million respectively compared to \$0.1 million and \$0.1 million for the same periods in the prior fiscal year. Interest income for the comparative periods has been presented in accordance with the presentation in the current period and reflects a reclassification from revenue to interest income of \$0.07 million and \$0.1 million for the three and six months ended December 31, 2006 respectively and reflects a reclassification from interest expense to interest income of \$0.02 million and \$0.05 million for the three and six months ended December 31, 2006 respectively.

#### **Interest Expense**

Interest expense decreased to \$0.56 million and \$1.16 million in the three and six months ended December 31, 2007 respectively compared to \$0.85 and \$1.71 million respectively in the three and six months ended December 31, 2006 primarily due to lower interest rates on term debt outstanding.

## Income Tax Expense (Recovery)

As at June 30, 2007, the Company had recorded an income tax benefit of \$3.97 million primarily due to the reduction of the valuation allowance on future income tax assets. The reduction in the valuation allowance was based upon a number of factors, including the Peer 1's recent history of profitability and ability to utilize non-capital loss carry forwards, an analysis of the expected timing of reversals of temporary differences and budgeted and forecasted earnings, after adjusting for non-deductible expenditures. Although realization is not assured, the Company believes it is more likely than not that certain future tax assets will be realized and therefore a benefit has been recorded. In future periods, income tax expense will be recorded based on the Company's expected statutory tax rate adjusted for permanent items. This will be subject to periodic assessments of the valuation allowance which could result in increases or decreases to the future tax asset and income tax expense.

For the three months ended December 31, 2007, Peer 1 recorded total income tax expense of \$1.38 million.

The Company's effective tax rate of 42.4% differs from the combined federal, provincial and state tax rates due to the effect of non-deductible expenditures.

## SUMMARY OF QUARTERLY RESULTS

The following table sets out certain operating results and balance sheet items of the Company for the past eight quarters.

	Quarter Ended (in thousands \$)							
	31-Mar 2006	30-Jun 2006	30-Sep 2006	31-Dec 2006	31-Mar 2007	30-Jun 2007	30-Sep 2007	31-Dec 2007
	(US\$)	(US\$)	(US\$)	(US\$)	(US\$)	(US\$)	(US\$)	(US\$)
Revenue	17,627	17,117	17,450	18,065	18,755	19,828	20,959	22,224
Operating Profit	1,224	621	1,736	2,218	1,915	1,482	2,825	3,910
Net Income (Loss)	(355)	(1,333)	249	849	230	2,303	1,246	1,882
Basic income (loss) per share	(0.01)	(0.01)	0.00	0.01	0.00	0.02	0.01	0.02
Fully diluted income (loss) per share	(0.01)	(0.01)	0.00	0.01	0.00	0.02	0.01	0.02

## Liquidity and Capital Resources

Peer 1 has historically financed operations through cash generated from operations, sale of common and preferred shares and issuance of debt. As at December 31, 2007, the Company had cash and cash equivalents of \$7.2 million (including \$0.25 million in restricted cash – see Off-Balance Sheet Arrangements section), compared to \$9.26 million (including \$0.5 million in restricted cash) as at June 30, 2007. The Company had notes payable of \$17.7 million as at December 31, 2007 compared to \$19.6 million of notes payable as at June 30, 2007.

The Company had a working capital deficit of \$2.7 million at December 31, 2007 compared to a working capital deficit of \$2.8 million as the end of September 30, 2007.

The working capital deficit of \$2.7 million at December 31, 2007 includes deferred revenue of \$3.04 million and current portion of notes payable of \$3.33 million. The change in accounts receivable and the corresponding change in deferred revenue for the three months ended December 31, 2007 are

largely due to a change in the timing of billing. The Company anticipates current liquidity and cash generated from operations to be sufficient to fund existing operations for the foreseeable future.

### **Operating Activities**

Cash flow from operating activities for the three months ended December 31, 2007 and 2006 was \$3.72 million and \$3.55 million, respectively. Cash flow from operating activities for the six months ended December 31, 2007 and 2006 was \$9.05 million and \$6.11 million, respectively. The increase in cash provided by operations for the three and six months ended December 31, 2007 resulted primarily from increased cash flow from income for the period. Excluding changes in non-cash working capital items, Cash Flow from operating activities for the three months ended December 31, 2007 and 2006 was \$5.65 million and \$3.87 million, respectively. Cash flow from operating activities excluding changes in non-cash working capital for the six months ended December 31, 2007 and 2006 was \$10.33 million and \$8.3 million, respectively.

### **Investing Activities**

Cash used for investing activities for the three months ended December 31, 2007 and 2006 was \$6.48 million and \$3.29 million, respectively. Cash used by investing activities for the six months ended December 31, 2007 and 2006 was \$9.92 million and \$7.05 million, respectively. The increase in use of cash for the three and six month period ended December 31, 2007 compared to the same periods last year is primarily a result of the use of approximately \$2.9 million during the quarter in connection with the upgrade of the network.

### **Financing Activities**

Net cash outflows from financing activities for the three months ended December 31, 2007 was \$0.99 million compared to cash outflows from financing of \$0.79 million for the three months ended December 31, 2006. Cash outflows from financing activities for the six months ended December 31, 2007 was \$0.93 million compared to cash provided by financing activities of \$0.1 million for the six months ended December 31, 2006. The decrease in cash provided by financing activities for the six months ended December 31, 2007 compared to the same period last year is primarily a result of \$1.8 million in net proceeds received from the sale leaseback of the leased data centre property in Miami in the six months ended December 31, 2006, offset by \$1.0 million received from the issuance of share capital in the six months ended December 31, 2007.

### **OFF-BALANCE SHEET ARRANGEMENTS**

As of December 31, 2007 Peer 1 has provided one letter of credit totaling US\$0.25 Million as security to a landlord for a facility lease. The security for the facility lease will be required for the term of the lease. The letter of credit is secured by way of a term deposit which is included in the reported cash balance. The financial statements classify the term deposit as restricted cash.

### **TRANSACTIONS WITH RELATED PARTIES**

Peer 1 entered into a number of related party transactions with companies either owned or subject to significant influence by management, directors and principal shareholders.

At December 31 amounts due to and from related parties were as follows:

	<b>FY2008</b>	<b>FY2007</b>
Accounts receivable from related companies	\$687	\$7,934
Accounts payable to related party	-	\$9,248

During the six month period ending December 31, 2007 transactions with related parties were as follows:

	<b>FY2008</b>	<b>FY2007</b>
Revenues earned	\$32,369	\$60,188
Other expenses incurred	\$101,657	\$264,608

These transactions are in the normal course of operations and are measured at their exchange amounts. Other expenses incurred include management and consulting fees of \$91,342.

Details of related party transactions for the three months ended December 31, 2007						
Related person or entity	Related person	A/R	A/P	USD		
				Revenue	Interest	Other
Code Marketing Ltd.	Lance Tracey					30,555 Management fees
E-Xact Transactions Ltd.	Scott Shaw, Lance Tracey	(218)		11,671		197 E-Xact provides Peer 1 with credit card gateway processing services
Fatport	Michael Cytrynbaum	904		1,625		Revenue from contract to provide colocation and bandwidth in Vancouver.
				687	-	13,296
						-
						30,752

## SUBSEQUENT EVENTS AND PROPOSED TRANSACTIONS

- On January 17, 2008 – Peer 1 announced that the Company now offers Fibre Attached Storage (FAS) system options on its managed Storage-Area-Network (SAN) to deliver high performance and customizable data sharing and storage capability. The service provides customers of all sizes with fast, high performing Storage Area Network at an affordable price point. The FAS solution is ideal for both fast growing businesses and established companies, such as SaaS, data warehousing or high transactional e-commerce environments, that require limitless amounts of storage, scalability and performance capabilities. The system uses the EMC SAN infrastructure, based in Peer 1's Atlanta, Miami and Fremont, Calif. data centers, which provides customers diverse geographic options. It is also fully customizable depending on the business requirements and growth structure of the customer. Peer 1's FAS offering is fully supported by internal Peer 1 storage experts and support professionals to ensure that customers receive the best support and expertise possible.

## **OUTSTANDING SHARE DATA**

Peer 1 has authorized share capital of unlimited common shares without par value and unlimited preferred shares without par value. At December 31, 2007 118,463,295 common shares were issued and outstanding. As of the date of this MD&A 118,463,295 common shares were issued and outstanding.

At December 31, 2007 3,139,904 warrants for the purchase of shares ranging in price from US\$0.23 to CAD\$0.40 (approximately US\$0.404) were outstanding. As the date of this MD&A no warrants have been exercised or issued subsequent to the end of the quarter.

As at December 31, 2007 9,185,500 stock options were outstanding under the Company's stock option plan. Subsequent to the quarter ended December 31, 2007 and as of the date of this MD&A, nil options were exercised and nil additional options have been granted. Stock options outstanding as of the date of this MD&A are 9,185,500.

If all warrants and options were exercised there would be a total of 130,788,699 shares outstanding as of the date of this MD&A.

## **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, 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 customers as well as overall historical collection trends. Our allowance varies by line of business and ranges from approximately 1-2.5% of annual revenues in the bandwidth and co-location business and approximately 1% in the dedicated hosting lines of business.

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

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

The measurement of income tax assets and any income tax valuation allowance is based upon estimates of future taxable income and the expected timing of reversals of temporary differences.

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

## **CHANGES IN ACCOUNTING POLICIES**

Effective July 1, 2007, the Company adopted the new recommendations of the Canadian Institute of Chartered Accountants (CICA) Handbook section 1530, Comprehensive Income Section 3251, Equity; section 3855, Financial Instruments – Recognition and Measurement; and, section 3865, Hedges, retroactively without restatement. These new Handbook sections, which apply to fiscal years

beginning on or after October 1, 2006, provide requirements for the recognition and measurement of financial instruments and on the use of hedge accounting. Section 1530 establishes standards for reporting and presenting comprehensive income, which is defined as the change in equity from transactions and other events from non-owner sources. Other comprehensive income refers to items recognized in comprehensive income that are excluded from net income calculated in accordance with generally accepted accounting principles. Under the new standards, policies followed for periods prior to the effective date generally are not reversed and therefore, the comparative figures have not been restated. The adoption of these Handbook sections had no impact on opening deficit.

Under section 3855, financial instruments must be classified into one of these five categories: held for trading, held-to-maturity investments, loans and receivables, available for sale financial assets or other financial liabilities. All financial instruments, including derivatives, are measured in the balance sheet at fair value except for loans and receivables, held-to-maturity investments and other financial liabilities which are measured at amortized cost. Subsequent measurement and changes in fair value will depend on their initial classification, as follows: held-for-trading financial assets are measured at fair value and changes in fair value are recognized in net income; available-for-sale financial instruments are measured at fair value with changes in fair value recorded in other comprehensive income until the investment is derecognized or impaired at which time the amounts would be recorded in net income.

Upon adoption of these new standards, the Company designated its cash, cash equivalents and restricted cash as held-for-trading, which are measured at fair value. Accounts receivable are classified as loans and receivables, which are measured at amortized cost. Accounts payable, accrued liabilities and notes payable, are classified as other financial liabilities. The Company had neither available for sale, nor held-to-maturity instruments during the three and six months ended December 31, 2007.

The Company had no “other comprehensive income or loss” transactions during the three months and six months ended December 31, 2007. The effect of the adoption of these standards was that (\$0.01 million), the balance of Cumulative translation adjustment, was reclassified to Accumulated other comprehensive loss.

The carrying values of accounts receivable, notes payable, accounts payable and accrued liabilities, approximates fair value at December 31, 2007.

## **CONTROL OVER FINANCIAL REPORTING**

Management has evaluated whether there were changes to its internal controls over financial reporting during the quarter ended December 31, 2007 that have materially affected, or are reasonably expected to materially affect, its internal controls over financial reporting. No such changes were identified.

## **ACCOUNTING POLICIES**

The Company prepares its financial statements on the basis of accounting principles generally acceptable in Canada. All accounting policies have been applied on a basis consistent with that of the previous year except as noted in changes in accounting policies.

## **RISKS**

### *Operating Results are Expected to Fluctuate*

The Company has experienced steady growth in its operating results on a quarterly and annual basis reflected in profitability and lower cost of debt. In view of the rapidly evolving nature of the Company's business, and the risks explained elsewhere in these risk factors the Company believes that period-to-period comparisons of operating results should not be relied upon as the sole indication of future performance. The fluctuation in the Company's operating results may cause the market price of its common shares to decline. The Company expects that operating results may fluctuate in the foreseeable future due to a variety of factors, including:

- Changes in general economic conditions and specific market conditions in the telecommunications and Internet industries
- The timing and magnitude of operating expenses, capital expenditures and acquisitions.
- The cost and availability of adequate public utilities, including power.

Any of the foregoing factors, or other factors discussed elsewhere in this Management's Discussion & Analysis could have a material adverse effect on the Company's business, results of operations or financial condition. Although the Company has experienced quarterly revenue growth, this growth pattern is not necessarily indicative of future operating results.

### *History of Losses*

Although the Company generated net profits in each quarter of fiscal 2007, it has experienced losses in prior fiscal years. The Company cannot guarantee that it will generate, or continue to generate, profits in the future. If the Company does not continue to generate profits in the future, it may require additional sources of financing to meet ongoing operational requirements as well as any future expansions.

### *Dependence on Key Personnel*

The continued success of the Company is largely dependent on the personal efforts and abilities of its senior management and certain other key personnel. The loss of key employees or the Company's inability to attract or retain other qualified employees could have a material adverse effect on the Company's business, results of operations and financial condition.

### *Acquisitions*

The Company may seek to acquire related or complementary businesses or assets. As a result of these acquisitions, the Company may be required to incur additional debt and expenditures and issue additional common shares, which may dilute existing shareholders' ownership interest in the Company and may delay, or prevent, the Company's profitability. In addition potential acquisitions may expose the company to inherent risks of integration, consumption of senior and key employees' time and efforts that may have an adverse impact on the consolidated business. The Company cannot assure investors or potential investors that it would successfully overcome these risks or any other problems encountered with possible acquisitions.

### *Management of Growth*

The Company has completed its previously announced expansions in Toronto, Vancouver and San Antonio. The Company anticipates that additional significant expansion will continue to be required in order to extend its position in the North America data centre infrastructure market. These strategic initiatives as well as future initiatives are expected to place certain demands on the Company's

management, operational and financial resources. Management may be unable to attract, retain, motivate and manage required personnel or to successfully identify, manage and exploit existing and potential market opportunities. If it is unable to manage growth effectively or accomplish any of the growth objectives outlined above, the business, financial condition and results of operations of the Company could be seriously harmed.

#### Competition

The Company operates in a competitive market. The Company competes on the basis of certain factors including the ability to provide its customers with reliable and scalable IT operations and infrastructure, the use of private backbone connections and the ability to provide redundant, high-speed connectivity to the Internet. There can be no assurance that the Company's current and future competitors will not be able to develop co-location services or other infrastructure expertise comparable or superior to those developed by the Company or to adapt more quickly than the Company to new technologies, evolving industry standards or customer requirements.

#### Price Sensitive Market

The Company's services are currently priced on a value basis and accordingly command a premium over certain other alternatives. However, the competitive market in which the Company conducts its business could require the Company to reduce its prices. If its competitors offer discounts on certain products or services in an effort to recapture or gain market share or to sell other software products, the Company may be required to lower prices or offer other favourable terms to compete successfully. Any such changes would likely reduce the Company's margins and could adversely affect operating results. Some of the Company's competitors may bundle products and services that compete with the Company's for promotional purposes or as a long-term pricing strategy or provide guarantees of prices and product implementations. These practices could, over time, limit the prices that the Company can charge for its products. If the Company cannot offset price reductions with a corresponding increase in sales volumes or with lower spending, then the reduced revenues resulting from lower prices would adversely affect the Company's margins and operating results.

#### Security Breaches

All data systems and services are subject to physical and network security risks. Attempts may be made to damage systems of both Peer 1 and its customers. While Peer 1 provides various levels of service to customers and Peer 1's security practices are industry leading, effective attacks on Peer 1's systems or systems of specific customers could adversely affect services provided to such customers and to non-targeted customers.

Concerns over the security of Internet transactions and the privacy of users may also inhibit the growth of the Internet generally, particularly as a means of conducting commercial transactions.

#### Electrical Power Outages

The Company's data centres are susceptible to the regional costs of power, electrical power shortages and planned or unplanned power outages caused by these shortages. The Company attempts to limit exposure to system downtime by using backup generators and UPS systems. Power outages that last beyond the Company's backup and alternative power and generator fuel supply arrangements could harm the Company's customers and business.

#### Physical Infrastructure

The Company's business depends on providing its customers with fully reliable services. The services that the Company provides are subject to failure resulting from a number of factors, including:

- human error
- physical or electronic security breaches
- fire, earthquake, flood and other natural disasters
- water damage
- power loss
- sabotage and vandalism
- failure of the Company's third party service providers

Problems at the Company's data centres, whether or not within the Company's control, could result in service interruptions or significant equipment damage. The Company has service level commitments to each of its customers. As a result, service interruptions or significant equipment damage at a data centre could result in claims being made against the Company pursuant to the terms of its various service level agreements. Such claims could have a material adverse effect on the Company's financial performance and operating results.

#### Potential for Liability

There is a risk that the Company's services may not perform up to expectations. While the Company contractually limits its liability for damages arising from its provision of services, there can be no assurance that they will be enforceable in all circumstances or in all jurisdictions. Furthermore, litigation, regardless of contractual limitations, could result in substantial cost to the Company, divert management's attention and resources from the Company's operations and result in negative publicity that may impair the Company's ongoing marketing efforts. Although the Company benefits from its general liability insurance, there is no assurance that this insurance will cover the claims or that the claims will not exceed the insurance limit under its current policies.

#### Data Centre Facilities

All of the Company's data centres are located in leased premises. While the Company is in compliance with all material terms of its leases, if the lease for any data centre was terminated, or if the Company were not able to renew or extend the lease for a data centre, the Company's operating results could be materially adversely affected if it had to relocate premises.

#### Reliance on Third Parties

In order to be able to provide managed bandwidth services the Company purchases bandwidth from, or enters into settlement-free interconnection arrangements with, several Internet service providers. The Company cannot provide any assurance that these Internet service providers will continue to provide service to the Company on a cost-effective basis or on otherwise competitive terms, if at all, or that the Company will be able to acquire additional network capacity to adequately meet future customer demand. If the Company is not able to maintain direct connections to multiple backbone networks, then its operating results may be materially adversely affected. In addition, in order to provide managed bandwidth services and other managed services the Company contracts directly with third party service providers. These services require the Company to enter into fixed term contracts. If the Company experiences the loss of a customer who has purchased managed bandwidth or managed services, the Company will remain obligated to continue to pay such third parties for the term of the underlying contracts. The payment of these obligations without a corresponding payment from a customer will reduce the Company's financial resources and may have a material adverse effect on the Company's financial performance and operating results.

#### Establishment and Expansion of Brand Name

The Company's success in gaining and increasing market acceptance of its products and services depends in part on its ability to build, maintain and expand its brand name. In order to do so, substantial additional expenditures on marketing initiatives may be required. In addition, significant

resources must be devoted to ensure that the Company's customers receive a high level of service. A failure to promote and maintain the Company's brand would impair its ability to achieve market acceptance and would substantially impact its business, operating results and financial condition.

#### Regulatory Developments

The Company currently operates in a largely unregulated environment. Various laws and governmental regulations governing Internet related services, related communications services and information technologies remain largely unsettled. It may take many years to determine whether and how existing laws, such as those governing intellectual property, privacy, libel, telecommunications services and taxation apply to the Internet and to the Company's services.

The compliance with, or adoption or modification of laws or regulations relating to the Internet in Canada or elsewhere, or the unfavourable interpretation of existing laws, could materially adversely affect the Company's business, operating results and financial condition.

#### Adequate Intellectual Property Protection

The Company's success depends in part on its ability to protect its intellectual property. The Company relies on various intellectual property protections, including employment agreements, contractual provisions, internal protocols, copyright, trademark and trade secret laws, to preserve its intellectual property rights. Despite these precautions, it may be possible for third parties to obtain and use the Company's intellectual property without authorization. Policing unauthorized use of intellectual property is difficult, and some foreign laws do not protect proprietary rights to the same extent as the laws of Canada. To protect the Company's intellectual property, the Company may become involved in litigation, which could result in substantial expenses, divert the attention of management, cause significant delays, materially disrupt the conduct of the Company's business or adversely affect the Company's revenue, financial condition and results of operation.

#### Future Capital Needs; Uncertainty of Additional Funding

The Company may require additional working capital in the future to finance the development and expansion of its business after its present resources are deployed. If additional funds are raised from the issuance of equity or equity linked debt securities, the percentage ownership of the then current shareholders of the Company will be reduced, and the newly issued securities may have rights, preferences or privileges senior to or equal to those of the holders of the Company's common shares.

No assurance can be given that additional funding will be available or that, if available, it will be available on terms favourable to the Company or its shareholders. If adequate funds are not available to satisfy the Company's capital requirements, the Company may be required to curtail its operations significantly.

#### Market Demand for Available Capacity

The Company currently has available capacity in certain data centres and is in the process of adding additional capacity in existing and new data centres. There can be no assurance that the existing or future market demand will be sufficient to fill this available capacity. Should the demand for the Company's data centre services decline or fail to increase, this may negatively affect the Company's ability to capitalize on its high operating leverage and may adversely affect the Company's future financial performance.

#### Technological Change

The markets in which the Company operates are characterized by changing technology and evolving industry standards.

Failure or delays by the Company to develop its products and services to respond to industry or user trends could have a material adverse effect on the Company's business, results of operations and financial condition.

The Company's ability to anticipate changes in technology, technical standards and product offerings will be a significant factor in the Company's success in expanding into new markets.

*Future Sales by Significant Shareholders*

If at any time the Company's significant shareholders sell substantial amounts of the Company's common shares in the public market, the market price of the common shares may fall. The perception among investors that these sales will occur could also produce this effect.

*Share Price Volatility and Market for the Securities*

The market price of the Company's common shares may be volatile and could be subject to wide fluctuations due to a number of factors, such as actual or anticipated fluctuations in the Company's results of operations or analysts estimates, introduction of new products, economic changes in North America.

*Currency Fluctuations*

The Company's revenues and costs are affected by fluctuations in the rate of exchange between the Canadian dollar and the US dollar. Exposure to exchange rate fluctuations exists because a portion of the Company's revenues, trade receivable and trade payables are in Canadian and US dollars depending on the location of business. The Company expects that Canadian and US dollar sales and expenses will continue to account for a material portion of operations for the foreseeable future. As a result, exchange rate fluctuations may affect the Company's revenue and earnings growth materially in the future.

**OTHER INFORMATION**

Additional information relating to the company is available on SEDAR at [www.sedar.com](http://www.sedar.com).