

peer1

NETWORK | CO-LOCATION | DEDICATED HOSTING



THREE AND NINE MONTHS ENDED MARCH 31, 2008 AND 2007  
**MANAGEMENT'S DISCUSSION & ANALYSIS**

**MANAGEMENT'S DISCUSSION AND ANALYSIS  
OF INTERIM FINANCIAL RESULTS  
FOR THE THREE AND NINE MONTHS ENDED MARCH, 2008**

*This Management Discussion and Analysis ("MD&A") of Peer 1 Network Enterprises, Inc. ("Peer 1" or "the Company"),, dated May 13, 2008, should be read in conjunction with Peer 1's unaudited third 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 may include or incorporate by reference certain statements that are "forward-looking statements". All statements, other than statements of historical fact, included or incorporated by reference in this MD&A that address activities, events or developments that the Company or its management expects or anticipates will or may occur in the future, including such things as future capital expenditures (including the amounts and nature thereof), business strategies and measures to implement strategies, goals, expansion and growth of the Company's business and operations, plans and references to the Company's future success, and other such matters, are forward-looking statements. These forward-looking statements are based on certain assumptions and analyses made by the Company's management in light of their experience and perception of historical trends, current conditions and expected future developments, as well as other factors the Company's management believes is appropriate in the circumstances. However, whether actual results and developments will conform to the expectations and predictions of the Company's management is subject to a number of risks and uncertainties, including those risk factors discussed under "Risk Factors" and elsewhere in this MD&A and the documents incorporated by reference. Consequently, all of the forward-looking statements made in this MD&A and the documents incorporated herein by reference are qualified by these cautionary statements and other cautionary statements or factors contained herein or in documents incorporated by reference herein, and there can be no assurance that the actual results or developments anticipated by the Company and its management will be realized or, even if substantially realized, that they will have the expected consequences for, or effects on, the Company.

The forward-looking statements set forth herein reflect the Company's expectations as at the date of this MD&A and are subject to change after that date. Unless otherwise required by applicable securities laws, the Company and its management expressly disclaim any intention, and assume 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 21.42% to \$22.77 million for the three months ended March 31, 2008, compared to \$18.76 million for the three months ended March 31, 2007.
- Gross profit increased 47.57% to \$10.34 million for the three months ended March 31, 2008, compared to \$7.01 million for the three months ended March 31, 2007.

- Operating income increased 114.52% to \$4.11 million for the three months ended March 31, 2008, compared to \$1.92 million for the three months ended March 31, 2007.
- Income before income taxes was \$3.70 million for the three months ended March 31, 2008 compared to \$0.54 million for the three months ended March 31, 2007.
- Net income was \$2.2 million for the three months ended March 31, 2008, compared to \$0.23 million for the three months ended March 31, 2007.

### **Quarterly Key Developments**

- During the quarter ended March 31, 2008, the Company substantially completed implementation of its extensive upgrade of the Peer 1 IP network. The total estimated capital expenditure related to this upgrade is approximately \$4 million.
- On February 26th, Peer 1 announced that the Company has partnered with Microsoft to offer 50 free developer sandbox servers for a 30-day trial. Web developers now have a chance to work with full control on a collection of Microsoft website development applications in a dedicated hosting environment. This is a unique opportunity for developers and agencies to explore both the internal and external aspects of testing and developing a website and other online applications using some of the latest Microsoft software that has been pre-loaded in to the sandbox server and is connected into Peer 1's extensive online network infrastructure. Working together in this collaborative and supportive environment enables the developers to build applications and compatible offerings, which can better meet customer needs and increase both business and customer revenue.
- On January 17, 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 will provide customers of all sizes with fast, high performing Storage Area Network at an affordable price point. This is in response to a growing demand for online infrastructure and data storage. 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 CA data centers, which provides customers diverse geographic options. It is also fully customizable depending on the business requirements and growth structure of the customer.

### **OUR BUSINESS**

Peer 1 is a premier Internet infrastructure provider, delivering managed, self-managed, co-location and network services through 15 datacenters located in 12 cities across North America, all connected together by its own IP ("Internet Protocol") backbone network. Peer 1 is a full solution provider and the Company's services are designed to enable its customers to focus on their businesses rather than the complexities of maintaining or expanding their Internet infrastructure. Peer 1's principal target market is those small and medium-sized businesses whose activities are increasingly dependent upon the Internet.

## **INDUSTRY**

An increasing number of business critical applications are now delivered over the Internet. As a result, businesses of all sizes are evolving to depend on 24 hours a day, seven days a week, or 24-7, connectivity, availability and security of their IT systems. In addition, community and social based web applications, such as YouTube, Facebook or MySpace are revolutionizing the ways that users interact over the Internet. These dynamics are spurring the demand for increased Internet infrastructure availability.

Modern data centers must be designed and operated at a level approaching 100% of system availability. To achieve this, multiple redundant layers of power, bandwidth, network connectivity and cooling systems are now mandatory. The economic resources and technical expertise required to build and operate facilities of this kind are well beyond the capabilities of a typical small and medium-sized business.

The increasing capabilities and sophistication of web applications is driving small and medium-sized businesses to develop and deploy system architectures that are increasingly complex, creating a sense of urgency and demand for specialized Internet infrastructure solutions and services.

The Company has chosen to focus on small and medium-sized businesses worldwide. To effectively compete, this target market has become reliant on sophisticated Internet infrastructure that, in the past, has been typically deployed at larger enterprises. However, managing, monitoring, administering, and maintaining a sophisticated Internet infrastructure can rapidly deplete the limited resources of small and medium-sized businesses which need to be directed at core business activities. These complex and growing demands necessitate a closer relationship with a value-added, solutions oriented Internet infrastructure service provider such as Peer 1.

The Company views the North American market for Internet infrastructure as highly fragmented, with no single dominant player focused on the small and medium-sized business marketplace. Specifically, the Company believes the industry includes many small, regional providers that are limited in their ability to scale their service offerings or data center infrastructure.

The Company believes that there is a growing trend to outsource Internet infrastructure and related managed services to third-party providers. The Company expects this trend to remain healthy for the foreseeable future given the significant costs associated with attempting to deliver high quality Internet infrastructure solutions through an in-house approach. In particular, the Company believes that small and medium-sized businesses face significant challenges in trying to deliver these services on their own because of constraints related to technical expertise and cost. The Company believes that outsourcing these functions will allow organizations to focus capital and personnel resources on their core business operations, as opposed to Internet infrastructure.

## **SERVICES AND SOLUTIONS**

Peer 1 is a full solution provider and its services are designed to enable its customers to focus on their businesses rather than the complexities of maintaining or expanding their Internet infrastructure. The Company's four core services are: managed hosting, self-managed hosting, co-location and network services.

## **MANAGED HOSTING**

Managed hosting is an arrangement with a customer in which Peer1 provides them with the use of server and related technology and a collection of services designed to ensure the proper management of that technology in the light of the customer's objectives. These services and technology include the following:

- Peer 1 provides data backup and recovery solutions designed to make backups and restorations faster and more flexible with minimal customer impact.
- Peer 1 provides firewall technology to protect servers against online exploitation. Peer 1 customizes firewall rule sets in accordance with customer objectives with a view to balancing the need for protection from illegitimate access against the need to allow unimpeded legitimate access.
- Peer 1 provides dedicated switches and devices that provide a private communication link between servers and assist its customers in managing their bandwidth consumption.
- Peer 1 provides vulnerability scanning services to satisfy customer demands for periodic server security audits.
- Peer 1 provides advance system monitoring services to enable its customers to address potential problems before they become actual problems.
- Peer 1 provides load balancing services that enables customers to better handle high traffic loads by, among other things, adding more servers to server farms as they are needed and removing them when they are no longer needed. Load balancing services are ideal for customers that have clusters of servers in multiple locations, as it enables them to direct internet traffic between server nodes in Peer 1's different datacenters.
- Peer 1 provides a caching system that directs the customers' clients to the nearest caching server or node, allowing for faster delivery of web content than is possible without caching. This system is also made available as part of all of the Company's other services offerings.

## **SELF-MANAGED HOSTING**

Self-managed hosting arrangements are substantially similar to managed hosting arrangements except that in the former case the customer manages and administers the server, not the Company. The services made available to self-managed hosting customers take the form of automated tools to facilitate the provisioning of server solutions. They include the following:

- Peer 1 provides RapidReboot™ to enable customers to remotely restart their servers, eliminating the need for an on-site technician to manually re-start them.

- Peer 1 provides RapidRescue™ to enable servers running the Linux operating system to be rescued by the Company's customers from potentially fatal errors. Customers can recover and repair corrupted file systems, gain immediate access to the server, and boot the server into rescue mode without the help of an on-site technician.
- Peer 1 provides remote backup technology to enable customers to back-up their critical data on a separate device. Storage amounts can be increased and decreased by the customer via Peer 1's web portal, and any changes occur automatically.
- Peer 1 provides control panel technology designed to simplify and automate, and thereby reduce the costs associated with the management and administration of web sites.
- Peer 1 provides a variety of options for port speed and bandwidth allotment that can be tailored to meet the requirements of each customer.
- Peer 1 provides technology that allows customers to communicate between their web, database and other servers internally without going over the public Internet.

## **CO-LOCATION AND RELATED SERVICES**

Co-location arrangements are substantially similar to self-managed hosting except that co-location customers own the server hardware and technology which they house on Peer 1's premises in order to access Peer 1's high quality Internet infrastructure, large bandwidth capacity, redundant power supply, security and technical support. This type of arrangement also enables customers to easily increase the Internet-related aspects of their business with minimal disruption. Peer 1's co-location services include the following:

- Peer 1 hosts customer domain names on a fully redundant distributed environment providing the customer with fast performance and reliable uptime over the Internet.
- Peer 1's port monitoring service enables its customers to define their minimum and maximum thresholds for bandwidth and packets per seconds usage, and alerts them by email once the threshold has been reached. This service also enables Peer 1 customers to better manage network costs and alerts customers of reductions in traffic to their sites due to server crash, hardware failure or web site configuration issues.
- Peer 1 provides co-location customers with convenient, secure, browser-based access to servers located on its premises, allowing customers to remotely repair server problems. This device allows the remote installation of operating systems and server troubleshooting.
- Peer 1 provides load balancing services that enables customers to better handle high traffic loads by, among other things, adding more servers to server farms as they are needed and removing them when they are no longer needed. Load balancing services are ideal for customers that have clusters of servers in multiple locations, as it enables them to direct internet traffic between server nodes in different Peer 1 datacenters.

- Peer 1 offers a service that protects its customers' online presence by distributing an incoming Distributed Denial of Service Attack, minimizing the impact on their normal functioning.

## **IP BACKBONE NETWORK SERVICES**

Peer 1 has engineered one of the fastest and most reliable IP backbone networks in North America. Peer 1 has established 20 network points-of-presence, in some cases with multiple points-of-presence in a single city.

Peer 1 bundles network connectivity with all of its core service offerings and also attracts select customers wishing to have access to the benefits and security of the Peer 1 network without subscribing to other Peer 1 services. Peer 1 network operations are managed and serviced on a continuous basis.

The network is based on a series of dedicated links between Peer1 datacenters using multiple high speed connections and best-in-class network hardware. It is fully redundant, without any singly point of failure, and makes use of strategic peering relationships with over 500 other network providers. These relationships improve performance by reducing network latency, and they reduce the Company's telecommunications carrier costs.

## **GROWTH STRATEGY**

Peer 1 is pursuing a growth strategy that is focused on (1) organic growth, (2) leveraging Peer 1's automation capabilities and (3) pursuing additional growth opportunities through strategic acquisitions.

### **ORGANIC GROWTH**

Peer 1 seeks to increase its customer base and revenue by a continued focus on service excellence, the introduction of new service solutions, the cross selling of its service solutions to existing customers, the expansion of its geographical presence in North America and Europe, and the continuation and improvement of its sales and marketing activities. Peer 1 will also continue using its relative financial strength and size to secure strategic arrangements with other service providers and vendors that might not be available to its smaller competitors due to their size.

### **LEVERAGING AUTOMATION**

Peer 1 pursues an operational strategy aimed at increasing the use of automation in respect of the manner in which the Company provisions and delivers its service solutions. This benefits its customers through more effective and faster deployment of its service solutions and reduces the Company's costs and commensurately increases its margins in comparison with an operational strategy that does not accommodate automation.

### **STRATEGIC ACQUISITIONS**

Peer 1 will seek to exploit the opportunities presented by fragmented industry in which it operates in order to accelerate its growth through strategic acquisitions. The Company's senior management team and Board of Directors have considerable acquisition experience and have completed and integrated two major acquisitions during the three years ended June 30, 2007.

## 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 Nine Months Ended March 31 (unaudited - prepared by management) (in thousands of United States Dollars, except per share amounts)				
	Three Months Ended March 2008 US\$	Three Months Ended March 2007 US\$	Nine Months Ended March 2008 US\$	Nine Months Ended March 2007 US\$
<b>Revenue:</b>				
Colocation Services	7,070	5,402	20,402	15,501
Dedicated Hosting Services	15,702	13,353	45,553	38,769
	<u>22,772</u>	<u>18,755</u>	<u>65,955</u>	<u>54,270</u>
<b>Cost of Sales</b>	<u>12,431</u>	<u>11,747</u>	<u>36,513</u>	<u>33,711</u>
<b>Gross Profit</b>	10,341	7,008	29,442	20,559
<b>Operating expenses</b>	<u>6,232</u>	<u>5,092</u>	<u>18,599</u>	<u>14,690</u>
<b>Operating Income before other items</b>	4,109	1,916	10,843	5,869
<b>Other Items:</b>				
<b>Interest Income</b>	(64)	(69)	(290)	(216)
<b>Amortization of preferred share discount</b>	-	389	-	1,120
<b>Interest expense - long term</b>	471	814	1,631	2,521
<b>Interest accretion on notes payable</b>	22	54	66	164
<b>Integration costs</b>	-	90	93	608
<b>Foreign exchange loss (gain)</b>	(15)	14	241	(24)
<b>Loss (Gain) on disposal of fixed assets</b>	(7)	82	(14)	128
<b>Income before income taxes</b>	<u>3,702</u>	<u>542</u>	<u>9,116</u>	<u>1,568</u>
<b>Future income tax expense (recovery)</b>	1,066	266	2,056	(359)
<b>Current income tax expense</b>	<u>434</u>	<u>46</u>	<u>1,730</u>	<u>599</u>
<b>Income tax expense</b>	<u>1,500</u>	<u>312</u>	<u>3,786</u>	<u>240</u>
<b>Net income and comprehensive income</b>	<u>2,202</u>	<u>230</u>	<u>5,330</u>	<u>1,328</u>
<b>Deficit, beginning of period</b>	(4,949)	(10,610)	(8,077)	(11,708)
<b>Deficit, end of period</b>	<u>(2,747)</u>	<u>(10,380)</u>	<u>(2,747)</u>	<u>(10,380)</u>

### 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.

In thousands \$	Three months ended March 31				Nine Months ended March 31			
	2008	%	2007	%	2008	%	2007	%
Revenue:								
Colocation	3,175	14%	2,518	13%	9,331	14%	7,226	13%
Bandwidth	2,589	12%	2,030	11%	7,461	11%	6,192	11%
Services	1,306	5%	854	5%	3,611	5%	2,083	4%
Colocation Services	7,070	31%	5,402	29%	20,402	31%	15,501	29%
Dedicated Hosting Services	15,702	69%	13,353	71%	45,553	69%	38,769	71%
<b>Total Revenue</b>	<b>\$ 22,772</b>	<b>100%</b>	<b>\$ 18,755</b>	<b>100%</b>	<b>\$ 65,955</b>	<b>100%</b>	<b>\$ 54,270</b>	<b>100%</b>

Consolidated revenue increased to \$22.77 million for the three months ended March 31, 2008 from \$18.76 million for the three months ended March 31, 2007. Consolidated revenue increased to \$65.96 million for the nine months ended March 31, 2008 from \$54.27 million for the nine months ended March 31, 2007. 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 March 31, 2008 compared to the three months ended March 31, 2007 as a result of the increased value of Canadian dollar denominated sales totaled \$0.9 million and was \$0.42 million, \$0.34 million and \$0.14 million for Colocation, Bandwidth and Services revenue respectively. The increase in revenue for the nine months ended March 31, 2008 compared to the nine months ended March 31, 2007 as a result of the increased value of the Canadian dollar denominated sales totaled \$2.1 million and was \$0.98 million, \$0.81 million and \$0.29 million for Colocation, Bandwidth and Services revenue respectively.

Co-location revenues increased to \$3.18 million in the three months ended March 31, 2008 from \$2.52 million for the three months ended March 31, 2007; and to \$9.33 million for the nine months ended March 31, 2008 from \$7.23 million for the nine months ended March 31, 2007. The increase is attributable to increased pricing, increased sales volume and appreciation of the Canadian dollar against the US dollar.

Bandwidth revenues increased to \$2.59 million for the three months ended March 31, 2008 compared to \$2.03 million for the three months ended March 31, 2007; and to \$7.46 million for the nine months ended March 31, 2008 compared to \$6.19 million for the nine months ended March 31, 2007.

Dedicated hosting revenues increased to \$15.7 million for the three months ended March 31, 2008 from \$13.35 million for the three months ended March 31, 2007; and to \$45.55 million in the nine months ended March 31, 2008 from \$38.77 million for the nine months ended March 31, 2007. The increase for the three and nine month period ended March 31, 2008 is attributable to increased sales and addition of new customers

The Company's Canadian operations accounted for \$5.19 million of revenues in the three month period ended March 31, 2008 compared to \$3.93 million of revenues in the three months ended March 31, 2007; and for \$14.94 million of revenues in the nine month period ended March 31, 2008 compared to \$11.48 million of revenues in the nine months ended March 31, 2007. This change is related to increased co-location revenues in the Canadian operations for the three and nine months ended March 31, 2008 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 \$0.06 million and \$0.2 million for the three and nine months ended March 31, 2007 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 \$12.43 million for the three months ended March 31, 2008 from \$11.75 million for the three months ended March 31, 2007. Cost of sales as a percentage of revenue decreased to 55% in the quarter ended March 31, 2008 from 63% for the quarter ended March 31, 2007. Consolidated cost of sales increased to \$36.51 million for the nine months ended March 31, 2008 from \$33.71 million for the nine months ended March 31, 2007. Cost of sales as a percentage of revenue decreased to 55% in the nine months ended March 31, 2008 from 62% for the nine months ended March 31, 2007. The decrease in cost of sales as a percentage of revenue is attributable to reduced depreciation related to certain equipment acquired in September 2005 having been fully depreciated in addition to reductions in the cost of bandwidth. Revenue increased 21% for the three months ended March 31, 2008, compared to the three months ended March 31, 2007 while cost of sales increased 6% in the same period. Revenue increased 22% for the nine months ended March 31, 2008, compared to the nine months ended March 31, 2007 while cost of sales increased 8% in the same period.

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 hosting services 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 March 31				Nine months ended March 31			
	2008	%	2007	%	2008	%	2007	%
(In thousands \$)								
Total Operating Expenses	\$ 6,232	27%	\$ 5,092	27%	\$ 18,599	28%	\$ 14,690	27%

Total operating expenses increased to \$6.23 million for the three months ended March 31, 2008 from \$5.09 million for the three months ended March 31, 2007. Operating expenses as a percentage of revenue was 27% for both the three months ended March 31, 2008 and for the three months ended March 31, 2007. Total operating expenses increased to \$18.6 million for the nine months ended March 31, 2008 from \$14.69 million for the nine months ended March 31, 2007. Operating expenses as a percentage of revenue increased to 28% in the nine months ended March 31, 2008 from 27% for the nine months ended March 31, 2007.

General and administrative expenses accounted for 59% and 60% of total operating expenses for the three and nine months ended March 31, 2008 respectively compared to 58% and 59% for the three and nine months ended March 31, 2007 respectively. The increase in general and administrative expenses as a percentage of operating expenses for the three and nine months ended March 31, 2008 is in part attributable to higher compensation expense including higher stock based compensation.

Sales and marketing expenses accounted for 34% and 32% of total Operating Expenses for the three and nine months ended March 31, 2008 respectively compared to 28% and 26% for the three and nine months ended March 31, 2007 respectively. The increase in sales and marketing expenses as a percentage of operating expenses for the three and nine months ended March 31, 2008 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 nine months ended March 31, 2008 was \$0.1 million and \$0.3 million respectively compared to \$0.1 million and \$0.2 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 \$0.06 million and \$0.2 million for the three and nine months ended March 31, 2007 respectively and reflects a reclassification from interest expense to interest income of \$0.01 million and \$0.06 million for the three and nine months ended March 31, 2007 respectively.

#### **Interest Expense**

Interest expense decreased to \$0.47 million and \$1.63 million in the three and nine months ended March 31, 2008 respectively compared to \$0.81 and \$2.52 million respectively in the three and nine months ended March 31, 2007 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 March 31, 2008, Peer 1 recorded total income tax expense of \$1.5 million.

The Company's effective tax rate of 40.5% 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 \$)							
	30-Jun	30-Sep	31-Dec	31-Mar	30-Jun	30-Sep	31-Dec	31-Mar
	2006	2006	2006	2007	2007	2007	2007	2008
	(US\$)	(US\$)	(US\$)	(US\$)	(US\$)	(US\$)	(US\$)	(US\$)
Revenue	17,117	17,450	18,065	18,755	19,828	20,959	22,224	22,772
Operating Profit	621	1,736	2,218	1,915	1,482	2,825	3,910	4,109
Net Income (Loss)	(1,333)	249	849	230	2,303	1,246	1,882	2,202
Basic income (loss) per share	(0.01)	0.00	0.01	0.00	0.02	0.01	0.02	0.02
Fully diluted income (loss) per share	(0.01)	0.00	0.01	0.00	0.02	0.01	0.02	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 March 31, 2008, the Company had cash and cash equivalents of \$10.62 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 current portion of the Company's notes payable as at March 31, 2008 was \$3.29 million.

The Company had a working capital deficit of \$1.55 million at March 31, 2008 compared to a working capital deficit of \$1.28 million as the end of June 30, 2007. The working capital deficit of \$1.55 million at March 31, 2008 includes deferred revenue of \$3.1 million and current portion of notes payable of \$3.29 million. 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 March 31, 2008 and 2007 was \$8.02 million and \$4.71 million, respectively. Cash flow from operating activities for the nine months ended March 31, 2008 and 2007 was \$17.07 million and \$10.83 million, respectively. The increase in cash provided by operations for the three and nine months ended March 31, 2008 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 March 31, 2008 and 2007 was \$6.74 million and \$4.06 million, respectively. Cash flow from operating activities excluding changes in non-cash working capital for the nine months ended March 31, 2008 and 2007 was \$17.07 million and \$12.37 million, respectively.

### Investing Activities

Cash used for investing activities for the three months ended March 31, 2008 and 2007 was \$3.75 million and \$2.7 million, respectively; and for the nine months ended March 31, 2008 and 2007 was \$13.67 million and \$9.75 million, respectively. The increase in use of cash for the three and nine month period ended March 31, 2008 compared to the same periods last year is primarily a result of the acquisition of property and equipment including the acquisition of equipment related to the upgrade of the network.

## Financing Activities

Net cash outflows from financing activities for the three months ended March 31, 2008 was \$0.85 million compared to cash outflows from financing of \$0.13 million for the three months ended March 31, 2007. Cash outflows from financing activities for the nine months ended March 31, 2008 was \$1.79 million compared to \$0.03 million for the nine months ended March 2007. The decrease in cash provided by financing activities for the nine months ended March 31, 2008 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 nine months ended March 31, 2007, offset by \$1.0 million received from the issuance of share capital in the nine months ended March 31, 2008.

## OFF-BALANCE SHEET ARRANGEMENTS

As of March 31, 2008 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 March 31 amounts due to and from related parties were as follows (in thousands \$):

	<b>FY2008</b>	<b>FY2007</b>
Accounts receivable from related companies	\$1	\$9
Accounts payable to related party	-	\$11

During the nine month period ending March 31, 2008 transactions with related parties were as follows (in thousands \$):

	<b>FY2008</b>	<b>FY2007</b>
Revenues earned	\$52	\$73
Other expenses incurred	\$132	\$361

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 \$131 (in thousands of dollars).

**Details of related party transactions for the three months ended March 31, 2008 (in thousands \$)**

Related person or entity	Related person	USD				
		A/R	A/P	Revenue	Interest	Other Exp
Code Marketing Ltd.	Lance Tracey					30 Management fees
E-Xact Transactions Ltd.	Scott Shaw, Lance Tracey			18		0.4 1) Revenue from contract to provide colocation and bandwidth in Vancouver C\$17,463...2) E-Xact provides Peer 1 with credit card gateway processing services C\$367.74
Fatport	Michael Cytrynbaum	1		2		Revenue from contract to provide colocation and bandwidth in Vancouver
		<u>1</u>	<u>-</u>	<u>20</u>	<u>-</u>	<u>30</u>

**SUBSEQUENT EVENTS AND PROPOSED TRANSACTIONS**

- On April 18, 2008, The Toronto Stock Exchange (“TSX”) conditionally approved the listing of the common shares of the Company. Listing of the common shares is subject to the Company fulfilling all of the requirements of TSX. Subject to receipt by the TSX of the balance of documents required, it is proposed that the Company’s common shares commence trading on the TSX on Tuesday, May 20, 2008, under its current trading symbol “PIX”. Concurrent with listing on the TSX, the Company’s common shares will be delisted for trading on the TSX Venture Exchange.

**OUTSTANDING SHARE DATA**

Peer 1 has authorized share capital of unlimited common shares without par value and unlimited preferred shares without par value. At March 31, 2008 and the date of this MD&A 118,473,295 common shares were issued and outstanding. As of the date of this MD&A 118,473,295 common shares were issued and outstanding.

At March 31, 2008 3,139,904 warrants for the purchase of shares ranging in price from US\$0.23 to CAD\$0.40 (approximately US\$0.39) 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 March 31, 2008 9,195,500 stock options were outstanding under the Company’s stock option plan. Subsequent to the quarter ended March 31, 2008 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 9,195,500.

If all warrants and options were exercised there would be a total of 130,808,699 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. The Company's allowance varies by service offering and ranges from approximately 1-2.5% of annual revenues in the bandwidth and co-location services and approximately 1% from dedicated hosting services revenue.

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; section 3861 Financial Instruments – Disclosure and Presentation 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 and presentation 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 nine months ended March 31, 2008.

The Company had no “other comprehensive income or loss” transactions during the three months and nine months ended March 31, 2008. 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.

Prior to July 1, 2007 transaction and financing costs incurred to obtain financing were deferred and amortized on a straight-line basis over the term of the respective indebtedness. The unamortized balance was included in other assets. Pursuant to CICA Handbook Section 3855, effective July 1, 2007, transactions and financing costs are capitalized to the related liability and are measured at amortized cost using the effective interest method. The Company recalculated the amortization of the loan origination fees for the prior period using the effective interest method and concluded that the amount is immaterial, and therefore no adjustment has been made to opening balances at July 1, 2007.

The carrying values of accounts receivable, notes payable, accounts payable and accrued liabilities, approximates fair value at March 31, 2008.

During the quarter, management of the Company completed integration initiatives including the implementation of reporting systems which allow for the management and allocation of resources of the Company on the basis of a re-aligned, integrated operating structure. Prior to the completion of these initiatives, the Company was managed on the basis of separate lines of business comprising two reporting segments. Following the completion of these integration initiatives and re-alignment, management has determined that the Company operates in a single reportable operating segment which involves the provision of outsourced data center infrastructure services. The Company’s service offerings include the provision of physical space within its data centres, a complete suite of managed and unmanaged hosting services and high availability bandwidth connectivity.

## **RECENT ACCOUNTING PRONOUNCEMENTS**

In February 2008, the CICA issued Handbook Section 3064, Goodwill and Intangible Assets effective for annual and interim financial statements relating to fiscal years beginning on or after October 1, 2008. Section 3064, which replaces Section 3062, Goodwill and Other Intangible Assets, and Section 3450, Research and Development Costs, establishes standards for the recognition, measurement and disclosure of goodwill and intangible assets. The provisions relating to the definition and initial recognition of intangibles assets, including internally generated intangible assets, are equivalent to the corresponding provisions of IFRS IAS 38, Intangible Assets. This new standard is effective for the Company’s annual and interim financial statements commencing July 1, 2009. The Company is assessing the impact of the new standard on its financial statements.

## **CONTROL OVER FINANCIAL REPORTING**

Management has evaluated whether there were changes to its internal controls over financial reporting during the quarter ended March 31, 2008 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.

## **RISK FACTORS**

The Company and its shareholders are subject to the following risks, in addition to the risks mentioned elsewhere in this Annual Information Form:

### **Future Capital Needs**

The Company may require additional working capital in the future to finance the ongoing operation, development and expansion of its business. If additional funds are raised from the issuance of equity or equity linked debt securities, the percentage ownership of the Company's shareholders will be reduced, and the newly issued securities may have rights, preferences or privileges senior to those of the holders of its 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. Failure to secure adequate funds on reasonable terms may have a material adverse effect on the Company's business, results of operations and financial condition.

### **Competition**

The Company operates in an intensely competitive market. Some of its competitors have longer operating histories, significantly greater financial, technical, marketing and other resources, greater brand recognition and as the Company management believe, a larger base of customers. In addition, competitors may operate more successfully than Peer 1 or form alliances to acquire significant market share from Peer 1. These competitors may be able to adapt more quickly to new or emerging technologies and changes in customer requirements. They may also be able to devote more resources to the promotion, sale and development of their services and solutions than Peer 1 and there can be no assurance that Peer 1's competitors will not be able to develop services comparable or superior to those offered by Peer 1 at more competitive prices. As a result, in the future Peer 1 may suffer from an inability to offer competitive services or be subject to negative pricing pressure that would adversely affect its ability to generate revenue and adversely affect its operating results.

### **Price Sensitive Market**

The competitive market in which the Company conducts its business could require it to reduce its prices. If the Company's competitors offer discounts on certain products or services in an effort to recapture or gain market share or to sell other products, the Company may be required to lower its prices or offer other favorable terms to compete successfully. Any of these changes would likely reduce the Company's margins and could adversely affect its operating results. In addition, many of

the services and solutions that the Company provides and market are not unique to the Company and its customers and target customers may not distinguish the Company's services and solutions from those of its competitors. All of these factors could, over time, limit or reduce the prices that the Company can charge for its services and solutions. If the Company cannot offset price reductions with a corresponding increase in the number of sales or with lower spending, then the reduced revenue resulting from lower prices would adversely affect the Company's margins and operating results.

### **Limited Operating History**

The Company has a limited operating history upon which to evaluate its business and prospects, having commenced operations in 1999. Fiscal 2007 was the Company's first year of profitable operations. There can be no assurance that the Company will continue to be profitable. In view of the rapidly evolving nature of the Company's business, its limited operating history and the risks discussed elsewhere in these risk factors, period to period comparisons of operating results are not meaningful and should not be relied upon as an indication of future performance.

### **Dependence on Personnel**

The Company's continued success is largely dependant on the personal efforts and abilities of its executive officers and senior management. The Company's success also depends on its continued ability to attract, retain, and motivate its employees. In particular, the Company is dependent on its skilled technical employees and its sales and customer service employees, the competition for which is intense. There can be no assurance that the Company will be able to continue to attract, integrate or retain additional highly qualified personnel in the future. Any failure in this regard will adversely affect the Company's business.

### **Management of Growth**

The Company has completed past expansions at its data centers in Toronto, Vancouver and San Antonio. Additional significant expansion is required in order to maintain and extend the Company's position in the market. Expansions place pressure on the Company's management, operational and financial resources and there can be no assurance that management will be able to manage them effectively. If management does not manage them effectively, the Company's growth objectives will be prejudiced and its business, financial condition and results of operations will be adversely impacted.

### **Risk of Damage to Peer 1 Data Centers**

Hurricanes, fire, floods, power loss, telecommunications failures, earthquakes, break-ins, acts of war or terrorism, computer sabotage and similar events could damage or destroy the Company's data centers as well as the systems and information housed in those facilities. These problems could temporarily or permanently prevent the Company from fulfilling existing service obligations and from securing new customers. These events could also cause loss of service and data to customers. The Company's business could be seriously harmed even if these disruptions are temporary, its revenue could decline and its existing and prospective customers may lose confidence in its systems. The Company could also be required to make significant expenditures if its systems were damaged or destroyed, or if the delivery of its services to its customers were delayed or stopped by any of these occurrences. Disruptions in the Company's business caused by these events could have a material adverse effect on the Company's business, operating results and financial position.

## **Risk of Security Breach**

The Company's business involves the storage, management, and transmission of the proprietary information of customers. Although the Company employs control procedures to protect the security of this information, it cannot guarantee that these measures will be sufficient for this purpose. Breaches of the Company's security could result in misappropriation of personal information, suspension of hosting operations or interruptions in its services. If the Company's security measures are breached as a result of a third-party action, employee error or otherwise, and as a result customers' information becomes available to unauthorized parties, the Company could incur liability and its reputation would be damaged. This could lead to the loss of current and potential customers. If the Company experiences any breaches of its network security due to unauthorized access, sabotage, or human error, it may be required to expend significant capital and other resources to remedy, protect against or alleviate these and related problems. The Company also may not be able to remedy these problems in a timely manner, or at all. The Company's systems are also exposed to computer viruses, denial of service attacks and bulk unsolicited commercial email, or spam. Being subject to these events and items could cause a loss of service and data to customers, even if the resulting disruption is temporary. The Company could be required to make significant expenditures to repair its systems in the event that they are damaged or destroyed, or if the delivery of its services to its customers is delayed and its business could be harmed.

## **Electrical Power Outages**

The Company's data centers are susceptible to regional variations in the cost of power, electrical power outages, planned or unplanned power outages such as those that occurred in California during 2001 and the U.S. Northeast in 2003, natural disasters such as the tornados on the U.S. East Coast in 2004 and limitations on availability of adequate power resources. Power outages could harm the Company's customers and its business including the loss of its customers' data and extended service interruptions. While the Company attempts to limit exposure to system downtime by using backup generators and power supplies, it may not be able to limit its exposure entirely even with these protections in place. With respect to any increase in energy costs, the Company may not be able to pass these increased costs on to its customers which could have a material adverse effect on its business, results of operations and financial condition.

## **Potential Service Level Credits and Litigation**

The Company's revenue and profit depend on the reliability and performance of its services and solutions. The Company has contractual obligations to provide service level credits to almost all of its customers against future invoices if certain service disruptions occur. Although the Company's service agreements limit its liability for damages arising in those instances, there can be no assurance that they will function as the Company anticipates. Furthermore, litigation 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 its ongoing marketing efforts. There is no assurance that the Company's insurance will cover the claims or that the claims will not exceed the insurance limit under its current policies. There can be no assurance that the result of the litigation described under "Legal Proceedings" will not be materially adverse to the Company.

## **Economic Conditions**

Many of the Company's existing and target customers include small and medium-sized businesses. These businesses are more likely to be significantly affected by economic downturns than larger, more established businesses. Additionally, these businesses often have limited funds, which they

may choose to spend on items other than the Company's services and solutions. If a material portion of the small and medium-sized businesses that the Company services, or is looking to service, experience economic hardship, these small and medium-sized businesses may be unwilling or unable to expend resources on the services and solutions the Company provides, which would negatively affect the overall demand for the Company's services and could cause its revenue to decline.

### **Leased Data Centre Facilities**

The Company's data centers are located in leased premises, and there can be no assurance that the Company will remain in compliance with its leases and that they will not be terminated. Termination of a lease could have a material adverse effect on the Company's business, results of operations and financial condition.

### **Reliance on Third Parties**

The Company purchases bandwidth from, or enter into interconnection arrangements with, several Internet service providers. The Company cannot provide any assurance that these Internet service providers will continue to provide service to it on competitive terms, if at all, or that it 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 IP backbone networks, this could have a material adverse effect on the Company's operating results.

### **Regulatory Developments**

The Company operates in a largely unregulated environment, though various laws and governmental regulations govern other Internet related services. The adoption of new laws or extension of existing laws to any aspect of the Company's business could have a material adverse effect on its business, operating results and financial condition.

### **Adequate Intellectual Property Protection**

The Company relies upon trade secrets, proprietary know-how, and continuing technological innovation to develop new data center and IT infrastructure services and solutions and to remain competitive. If the Company's competitors learn of its proprietary technology or processes, they may use this information to produce data center and IT infrastructure services and solutions that are equivalent or superior to its services and solutions, and this could materially adversely affect its business, operations and financial position. The Company's employees and consultants may breach their obligations not to reveal the Company's confidential information, and any remedies available to the Company may be insufficient to compensate it. Even in the absence of such breaches, the Company's trade secrets and proprietary know-how may otherwise become known to its competitors, or be independently discovered by its competitors, which could adversely affect its competitive position.

### **Technological Change**

The markets in which the Company operates are characterized by rapidly changing technology and evolving industry standards. Failure or delays by the Company to develop products and services to respond to industry or user trends could have a material adverse effect on its 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 its success in expanding into new markets.

## **Acquisitions**

One part of the Company's growth strategy involves the acquisition of suitable businesses and technologies. A multitude of risks are inherent in all acquisitions, including risks relating to integration, financing and the impact of such financing on the Company's financial condition. There can be no assurance that the Company will be able to manage these risks adequately. Any failure in this regard could have a material adverse effect on the Company's business, results of operation and financial condition.

## **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).