PING & PEOPLE

# MANAGEMENT’S DISCUSSION & ANALYSIS
# FOR THE YEARS ENDED JUNE 30, 2011 AND 2010

**MANAGEMENT'S DISCUSSION AND ANALYSIS**
**OF FINANCIAL RESULTS**
**FOR THE FISCAL YEAR ENDED JUNE 30, 2011**

*This Management Discussion and Analysis ("MD&A") of Peer 1 Network Enterprises, Inc. ("PEER 1 Hosting" or "the Company"), dated September 19, 2011, should be read in conjunction with PEER 1 Hosting's audited annual financial statements for the fiscal year ended June 30, 2011 and the notes thereto, all of which can be found on [www.sedar.com](http://www.sedar.com). Unless otherwise noted, all figures 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.

## ADVERSE ECONOMIC CONDITIONS

Deterioration in economic conditions, such as occurred in the past three years makes it especially difficult for the Company to accurately forecast and plan future business activities. Such deterioration causes businesses to reduce spending on the Company services, lengthens the Company's new customer sales cycle and causes existing customers to do one or more of the following:

- cancel or reduce planned expenditures for the Company's services;
- seek to lower their costs by renegotiating their contracts with us;
- move their hosting services in-house; or
- switch to lower-priced solutions provided by us or the Company's competitors.

We cannot predict the timing, strength or duration of any economic slowdown or subsequent economic recovery. If the economy or markets in which we operate do not improve, the Company may record additional charges related to the impairment of goodwill and other long-lived assets, the Company's business, financial condition and results of operations could be materially and adversely affected.

For an analysis of other risks faced by the Company, please refer to the section "Risk Factors", included later in this MD&A.

## OVERVIEW

### Fiscal Financial Highlights

- PEER 1 Hosting's revenue increased 15.21% to $112.82 million for the year ended June 30, 2011, compared to $97.92 million for the year ended June 30, 2010. When adjusted for the effect of the differing exchange rates between the Canadian and US dollars for the comparative periods, the Company's increase in revenue was 13.92%.

- Gross profit increased 10.59% to $43.25 million for the year ended June 30, 2011, compared to $39.10 million for the year ended June 30, 2010.

- Operating income decreased 44.51% to $4.13 million for the year ended June 30, 2011, compared to $7.44 million for the year ended June 30, 2010.

- Income before income taxes was $0.96 million for the year ended June 30, 2011, compared to income before tax of $5.43 million for the year ended June 30, 2010.

- Net loss was $1.09 million for the year ended June 30, 2011, compared to net income of $2.24 million for the year ended June 30, 2010.

### Fiscal Year Developments

- On July 29, 2010, PEER 1 Hosting signed a multi-year colocation agreement with Capgemini Canada Inc., a member of the Capgemini Group, a leading global provider of consulting, technology and outsourcing services.

- On August 17, 2010, PEER 1 Hosting announced its participation in the VMware Service Provider Program ("VSSP") to offer customers Private Cloud solutions. VM Ware is the industry standard for Server Virtualization. It allows Peer 1 Hosting customers to divide one physical server into multiple smaller virtual servers, all running on the same hardware.

- On September 30, 2010, PEER 1 Hosting announced that IBM Canada is a PEER 1 Hosting platinum level colocation reseller.

- On November 9, 2010, PEER 1 Hosting entered into a credit agreement with a syndicate of lenders for a $45 million non-revolving term facility and a $30 million revolving credit facility.

PEER 1 Hosting can request an increase under the revolving facility by another $25 million, bringing the total potential credit available to $100 million.

- On January 1, 2011, PEER 1 Hosting entered into a long term lease agreement in the United Kingdom with plans to build out an approximately 50,000 square foot green data center facility at this site located in Portsmouth, on England's south coast. In addition to improving capacity in the European market, the build out of the Portsmouth data center will also allow PEER 1 Hosting to align its UK cost structure more closely with that of its North American operations.

- On May 3, 2011, PEER 1 Hosting announced the arrival of its IPv6 enabled 10GB backbone network, ahead of the imminent IPv4 address exhaustion. IPv6 ensures customers remain visible to all users around the world, irrespective of the networks or hardware they are using. The PEER 1 Hosting backbone will also offer the added network benefits of the IPv6 protocol including increased addressing capacity, more flexible security, the ability to expand infrastructure and accelerate business.

## THE BUSINESS

PEER 1 Hosting is a premier Internet infrastructure provider, delivering managed, dedicated, colocation and network services through 17 data centers located in 13 cities across North America and the United Kingdom, all connected together by its own Internet Protocol ("IP") backbone network. 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. The Company'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 Google, YouTube, Facebook, or Twitter have revolutionized the way 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.

PEER 1 Hosting has chosen to focus principally 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 Hosting.

The Company views the North American and European markets for Internet infrastructure as highly fragmented, with no single dominant player focused on the small and medium-sized business marketplace. Specifically, PEER 1 Hosting believes the industry includes many small, regional providers that are limited in their ability to scale their service offerings or data center infrastructure.

PEER 1 Hosting 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, PEER 1 Hosting 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. PEER 1 Hosting 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 Hosting 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, dedicated hosting, colocation and network services.

## MANAGED HOSTING

Managed hosting is an arrangement with a customer in which PEER 1 Hosting provides its customers 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 Hosting provides data backup and recovery solutions designed to make backups and restorations faster and more flexible with minimal customer impact.

- PEER 1 Hosting 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 Hosting provides dedicated switches and devices that provide a private communication link between servers and assist its customers in managing their bandwidth consumption.

- PEER 1 Hosting provides intrusion detection, log monitoring, SSL certificates, and vulnerability scanning services to satisfy customer demands for real-time and periodic server security audits.

- PEER 1 Hosting provides advance system monitoring services to enable its customers to address potential problems before they become actual problems.

- PEER 1 Hosting provides load balancing services that enable 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 Hosting's different data centers.

- PEER 1 Hosting 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.

- PEER 1 Hosting provides advanced database administration and clustering services to enable its customers to design and maintain highly available database architectures.

- PEER 1 Hosting provides VMWare® virtualization to enable its customers to implement disaster recovery and private clouds.

**DEDICATED HOSTING**

Dedicated hosting arrangements are delivered under the ServerBeach brand and 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 dedicated hosting customers take the form of automated tools to facilitate the provisioning of server solutions. They include the following:

- PEER 1 Hosting 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 Hosting 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 Hosting provides backup technology to enable customers to back-up their critical data on a separate device.

- PEER 1 Hosting 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 Hosting provides a variety of options for port speed and bandwidth allotment that can be tailored to meet the requirements of each customer.

- PEER 1 Hosting provides private network technology that allows customers to communicate between their web, database and other servers internally without going over the public Internet.

- PEER 1 Hosting provides virtualization to enable its customers to implement disaster recovery and private clouds.

- PEER 1 Hosting provides firewall technology to protect servers against online exploitation. PEER 1 Hosting 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.

## COLOCATION AND RELATED SERVICES

Colocation arrangements are substantially similar to dedicated hosting except that colocation customers own the server hardware and technology which they house on PEER 1 Hosting's premises in order to access PEER 1 Hosting'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 Hosting's colocation services include the following:

- PEER 1 Hosting hosts customer domain names on a fully redundant distributed environment providing the customer with fast performance and reliable uptime over the Internet.

- PEER 1 Hosting's port monitoring service enables its customers to define their minimum and maximum thresholds for bandwidth and packets per second usage, and alerts them by email once the threshold has been reached. This service also enables PEER 1 Hosting 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 Hosting provides colocation 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 Hosting offers a service that protects its customers' online presence by distributing an incoming Distributed Denial of Service Attack, minimizing the impact on their business.

## IP BACKBONE NETWORK SERVICES

PEER 1 Hosting has engineered one of the fastest and most reliable IP backbone networks in North America. PEER 1 Hosting has established 21 network points-of-presence, in some cases with multiple points-of-presence in a single city.

PEER 1 Hosting 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 Hosting network without subscribing to other PEER 1 Hosting services. PEER 1 Hosting network operations are managed and serviced on a continuous basis.

The network is based on a series of dedicated links between PEER 1 Hosting data centers using multiple high speed connections and best-in-class network hardware. It is fully redundant, without any single 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 Hosting is pursuing a growth strategy that is focused on: (1) organic growth, (2) leveraging its automation capabilities and (3) pursuing additional growth opportunities through strategic acquisitions.

## ORGANIC GROWTH

PEER 1 Hosting 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 Hosting 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 Hosting 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 Hosting will seek to exploit the opportunities presented by the fragmented industry in which it operates in order to accelerate its growth through strategic acquisitions.

## SELECTED ANNUAL INFORMATION

The following table sets forth selected financial information for PEER 1 Hosting for the periods indicated. The information is derived from and should be read in conjunction with, and is qualified in its entirety by reference to, PEER 1 Hosting's audited financial statements for the three years ended June 30, 2011, 2010, and 2009.

| | Year Ended June 30, | | |
|---|---|---|---|
| **(in $ thousands, except per share items)** | **2011** | **2010** | **2009** |
| **Statement of Operations Data** | | | |
| Hosting services | $ 82,134 | $ 70,172 | $ 67,229 |
| Bandwidth | 8,911 | 8,673 | 8,345 |
| Colocation | 15,505 | 13,558 | 12,069 |
| Services | 6,268 | 5,520 | 4,666 |
| Total revenue | 112,818 | 97,923 | 92,309 |
| Total cost of sales | 69,572 | 58,819 | 52,560 |
| Gross profit | 43,246 | 39,104 | 39,749 |
| Total operating expenses | 39,117 | 31,663 | 27,419 |
| Operating income | 4,129 | 7,441 | 12,330 |
| Non-operating expenses | 3,167 | 2,007 | 1,947 |
| Income taxes | 2,071 | 3,193 | 4,661 |
| Net income (loss) | $ (1,109) | $ 2,241 | $ 5,722 |
| Earnings (loss) per share – basic and diluted | $ ( 0.01) | $ 0.02 | $ 0.05 |
| **Balance Sheet Data** | | | |
| Cash | $ 7,803 | $ 2,321 | $ 15,744 |
| Current assets | 19,761 | 7,945 | 20,560 |
| Total assets | $ 113,594 | $ 72,646 | $ 66,430 |
| Current portion of notes payable | 5,008 | 3,000 | 2,250 |
| Current portion of obligation under capital lease | 237 | 376 | 211 |
| Current liabilities | 18,223 | 15,081 | 15,789 |
| Deferred gain | 335 | 414 | 493 |
| Deferred lease inducements | 541 | 557 | 664 |
| Notes payable | 53,104 | 16,404 | 12,303 |
| Obligation under capital lease | 11 | 232 | 363 |
| Total liabilities | 73,255 | 32,858 | 29,791 |
| Shareholders' equity | 40,339 | 39,788 | 36,639 |
| Total liabilities and shareholders' equity | $ 113,594 | $ 72,646 | $ 66,430 |

## Revenues

The Company's business model is based on recurring revenue streams for all of its main offerings. Customer revenue from its service offerings, which are invoiced monthly, generally continues on a go forward basis with a manageable level of customer churn. The Company defines "Churn" as the reduction of monthly revenue due to customer terminations as a percentage of total monthly recurring revenue before customer credits. With respect to Hosting Services, terminations typically result from customers who (i) no longer need Hosting Services, (ii) are unable to pay for Hosting Services, (iii) decide to provide their services in-house, or (iv) switch to another hosting provider. For the year ended June 30, 2011, the average monthly Churn rate with respect to Hosting Services was 1.2%.

Services revenue includes additional charges for power and setup fees for initial configuration and installation of services. Standard customer contracts range from month-to-month to five-year terms. Setup fees are typically billed once and only upon completion of configuration and installation.

| | **Year ended June 30,** | | | |
|---|---|---|---|---|
| | **2011** | **%** | **2010** | **%** |
| Revenue: | | | | |
| Colocation | 15,505 | 14% | 13,558 | 14% |
| Bandwidth | 8,911 | 8% | 8,673 | 9% |
| Services | 6,268 | 5% | 5,520 | 5% |
| Colocation services | 30,684 | 27% | 27,751 | 28% |
| Hosting services | 82,134 | 73% | 70,172 | 72% |
| **Total revenue** | **$ 112,818** | **100%** | **$ 97,923** | **100%** |

Revenue increased to $112.82 million (15.21%) for the year ended June 30, 2011 from $97.92 million for the year ended June 30, 2010. The increase in revenue is primarily attributable to organic growth, the effect of the increase in value of the Canadian dollar against the US dollar, and from the VIA Hosting Services, Inc. ("VIA") acquisition. When adjusted for the exchange rates in effect during the period, revenue for the year ended June 30, 2011 was $111.56 million. Taking into account the effect of the differing exchange rates between the Canadian and US dollars for the comparative period, revenue increased by 13.92% for the year ended June 30, 2011.

Colocation revenue increased to $15.5 million for the year ended June 30, 2011 compared with $13.56 million for the year ended June 30, 2010. The increase in colocation revenue is attributable to organic growth as well as the increase in the value of the Canadian dollar against the US dollar. The effect on revenue from the increase in value of the Canadian dollar against the US dollar was $0.81 million for the year ended June 30, 2011.

Bandwidth revenue increased to $8.91 million for the year ended June 30, 2011 compared with $8.67 million for the year ended June 30, 2010. The increase in bandwidth revenue for the year ended June 30, 2011 is primarily attributable to the increase in value of the Canadian dollars against the US dollar partly offset by pricing pressures in the market. The effect on revenue from the increase in value of the Canadian dollar against the US dollar was $0.45 million for the year ended June 30, 2011.

Hosting Services revenues increased to $82.13 million for the year ended June 30, 2011 from $70.17 million for the year ended June 30, 2010. The increase for the year ended June 30, 2011 is attributable to organic growth, and additional revenue from the VIA acquisition of approximately $2 million for the year ended June 30, 2011 respectively. Hosting Services revenues have not been materially impacted by foreign exchange effects as virtually all Hosting Services sales are currently denominated in US dollars.

PEER 1 Hosting's Canadian operations accounted for $26.03 million of revenue for the year ended June 30, 2011 compared with $20.15 million of revenue for the year ended June 30, 2010. This change is primarily related to organic growth and favorable foreign exchange effects of $1.26 million for the year ended June 30, 2011. The foreign exchange effects on revenue largely provide a natural hedge which offset exchange effects on expenses incurred in Canadian operations.

## Cost of Sales

Cost of sales relating to the Company's infrastructure and staffing are primarily fixed with changes primarily in connection with expansion. 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.

Cost of sales increased by $10.75 million for the year ended June 30, 2011 from $58.82 million for the year ended June 30, 2010. During the year ended June 30, 2011, the Company incurred costs $4.36 million related to its further expansion in the United Kingdom, which are included in cost of sales. Cost of sales as a percentage of revenue increased to 61.67% for the year ended June 30, 2011 from 60.07% for the year ended June 30, 2010.

The increase in cost of sales for the year ended June 30, 2011 compared to the same period in the prior year is primarily due to increased depreciation costs of $4.58 million, increased rent costs of $2.00 million, increased power costs of $1.92 million, increased software license costs of $1.07 million, increased bandwidth costs of $0.71 million, and increased repair and maintenance of $0.29 million.

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 colocation 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 Hosting Services is primarily affected by the costs of facilities, costs of servers, power 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.

| | **Year ended June 30,** | | | |
|---|---|---|---|---|
| (in thousands $) | **2011** | **%** | **2010** | **%** |
| Total operating expenses | $ 39,117 | 34.67% | $ 31,663 | 32.33% |

Total operating expenses increased by $7.45 million to $39.11 million for the year ended June 30, 2011 from $31.66 million for the year ended June 30, 2010. Operating expenses as a percentage of revenue increased to 34.67% for the year ended June 30, 2011 from 32.33% for the year ended June 30, 2010. The increase in operating expenses for the year ended June 30, 2011 is largely attributable to $3.93 million higher staff and training cost, $1.16 million higher advertising expenses, increased commission expenses of $1.08 million, increased professional services of $0.65 million, increased amortization expense of $0.47 million, increased office expenses of $0.27 million, increased rent of $0.21 million, increased property tax of $0.12 million, in part offset by lower bad debt expense of $0.16 million, lower travel expenses of $0.14 million and lower stock based compensation of $0.13 million. Total operating expenses for the year ended June 30, 2011 is comprised of $17.20 million (2010: $13.17 million) sales and marketing expenses, $17.03 million (2010: $15.42 million) general and administrative expenses, and $4.89 million (2010: $3.07 million) in expenses for technology and customer relations. During the year ended June 30, 2011, the company incurred expenses of $3.60 million related to its United Kingdom operations which are included in operating expenses, $1.26 million of which are categorized as general and administrative expenses and $2.31 million of which are categorized as selling and marketing expenses.

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

**Other Income and Expenses**

Interest income for the year ended June 30, 2011 was $0.017 million compared to $0.02 million for the year ended June 30, 2010. During the year ended June 30, 2011, the Company recorded an expense amount of $0.024 million related to the settlement of a legal claim. During the year ended June 30, 2010, the Company recorded a gain of $0.09 million related to a gain on insurance proceeds in connection to a claim made during the period and an expense in the amount of $0.44 million related to the settlement of a legal claim.

**Interest Expense**

Interest expense increased to $2.76 million for the year ended June 30, 2011 compared to $1.34 million for the year ended June 30, 2010. The increase in interest expense for the year ended June 30, 2011 was primarily due to $0.26 million of loan origination fees and $0.28 million of interest swap derivative losses expensed as a result of the debt refinancing, and higher debt.

**Income Tax Expense**

Income tax expense consists of:

| | **2011** | **2010** |
|---|---|---|
| Current tax expense | **$ 742** | $ 3,839 |
| Future tax expense (recovery) | **1,329** | (646) |
| | **$ 2,071** | $ 3,193 |

The decrease of $3.1 million in current tax expense during the year ended June 30, 2011 was primarily the result of a change in U.S. tax law which allowed for accelerated depreciation of certain assets for tax purposes. The effect of this change was to decrease U.S. taxes for the year and accordingly it reduced current tax expense. This change in U.S. tax law also led to an increase in the temporary timing difference between depreciation for U.S. tax purposes and depreciation for accounting purposes. This difference resulted in an increase to future tax expense during the year.

For the year ended June 30, 2011, Income tax expense varies from the amount that would be computed by applying the Canadian combined statutory income tax rate of 26.88% to income before income taxes of $0.96 million due to differences between the statutory rates in effect in Canada and the Company's US and UK subsidiaries, in addition to the effect of $1.25 million from non-deductible for tax purposes permanent differences comprised of differences related to stock based compensation with a tax effect of $0.63 million and non-deductibility of certain building fabric expenditures made during the year in the UK with a tax effect of $0.6 million.

**Financial Position**

The following chart outlines the significant changes in the balance sheet between June 30, 2011 and June 30, 2010.

| (in millions of US dollars) | Increase / (Decrease) | Explanation |
|---|---|---|
| Cash and cash equivalents | $ 5.48 | Refer to Statement of Cash Flows and liquidity and capital resources discussion. |
| Accounts receivable | 3.20 | Normal fluctuations from billing and collections cycles and input tax credits receivable of $2.34 million and billing increases. |
| Future income tax asset/liability | (0.98) | Decrease in permanent differences of $2.69 million, offset by increase in non-capital losses of $1.77 million |
| Prepaid expenses | (0.21) | Normal fluctuations from operations. |
| Income tax receivable | 2.25 | Payment of income taxes. |
| Property and equipment | 31.1 | Includes $16.45 million related to servers, $7.71 million related to data center, network and other equipment, $25.83 million related to data center expansion expenditure and leasehold improvement less depreciation of $18.83 million. |
| Equipment under capital lease | (0.26) | Depreciation. |
| Intangible assets | 0.65 | In-house and purchased software less amortization. |
| Accounts payable and accrued liabilities | 0.83 | Accounts payable payment cycle. |
| Notes payable | 38.71 | USD$13 million and CDN$30.1 million additional loan offset by principal repayment, and amortization of loan origination fees. |
| Derivative liabilities | 0.78 | Changes in fair value of the cash flow hedge |
| Share capital | 0.59 | Stock options and warrants exercised, less share repurchase and cancellation under NCIB. |
| Contributed surplus | 1.95 | Value of stock-based compensation and stock options exercised. |
| Retained earnings | (1.32) | Net loss of $1.11 million less $0.21 million related to stock repurchase charged to retained earnings. |
| Accumulated other comprehensive income | (0.58) | Change in value of derivative liability of $1.05 million less tax of $0.19 million and reclassification of loss on derivative on interest swap, amount of $0.28 million charged to net Income from other comprehensive income. |

## Liquidity and Capital Resources

During the year ended June 30, 2011, the Company completed the build-out of phase two and phase three at its flagship data center in the Greater Toronto Area. Additionally, the Company has started to build out a 50,000 square foot green data center in Portsmouth, England. Rather than building out large data center spaces all at once, the Portsmouth data center will incorporate a POD (Performance Optimized Datacenter) design. The first of four POD stages is scheduled for completion in the fall of 2011 at an initial cost of £10 million.

During the year ended June 30, 2011, the Company incurred capital expenditures related to the new Greater Toronto Area data center facility in the amount of $16.7 million, of which $15.98 million has been paid during the year ended June 30, 2011. Included in this amount is server cost of $2.33 million, of which $2.04 million has been paid during the year ended June 30, 2011.

During the year ended June 30, 2011, the Company incurred capital expenditures related to the Portsmouth data center facility in the amount of $11.16 million, of which $11.04 million has been paid during the year ended June 30, 2011.

PEER 1 Hosting has historically financed operations through cash generated from operations, sale of common and preferred shares and issuance of debt. As at June 30, 2011, the Company had cash and cash equivalents of $7.8 million compared to $2.32 million as at June 30, 2010. The current portion of the Company's notes payable as at June 30, 2011 was $5.01 million.

The Company had working capital of $1.34 million at June 30, 2011 compared to a working capital deficit of $7.14 million as at June 30, 2010. The increase in working capital is primarily due to additional drawdown on the credit facilities, partly offset by investments in property and equipment. The Company anticipates current liquidity and cash generated from operations to be sufficient to fund operations for the foreseeable future. As at June 30, 2011, the Company had available $15.82 million under its $75 million credit facilities.

### Operating Activities

Cash flow from operating activities for the year ended June 30, 2011 and 2010 was $17.08 million and $15.63 million, respectively. The increase in cash provided by operations for the year ended June 30, 2011 was primarily the result of higher amortization and lower income tax payments partly offset by net loss and higher accounts receivable.

### Investing Activities

Cash used for investing activities for the year ended June 30, 2011 and 2010 was $50.28 million and $32.48 million, respectively. The increase in use of cash for the year ended June 30, 2011 compared to the year ended June 30, 2010 is primarily a result of increased acquisition of property and equipment and expenditures on leasehold improvements related to Toronto data center expansion and UK expansion.

### Financing Activities

Net cash inflows from financing activities for the year ended June 30, 2011 was $37.76 million compared to net cash inflows of $3.27 million for the year ended June 30, 2010. The increase in cash inflow from financing activities for the year ended June 30, 2011 compared to the year ended June 30, 2010 is primarily due to proceeds from the drawdown under the National Bank of Canada – revolving and non-revolving term facilities. During the year ended June 30, 2011, $0.26 million of cash was used to repurchase the Company's own shares in connection with the normal course issuer bid. The Company believes that such purchases are in the best interest of PEER 1 Hosting shareholders and constitute an attractive investment opportunity and a desirable use of corporate funds that should enhance the value of remaining shares.

**Contractual Obligations**

| | Payments due by period | | | | |
|---|---|---|---|---|---|
| | Total | Less than 1 year | 1 to 3 years | 4 to 5 years | After 5 years |
| Notes Payable under non-revolving term facility [(a)] | 44,515 | 5,008 | 13,354 | 26,153 | - |
| Notes Payable under revolving term facility [(a)] | 14,515 | - | - | 14,515 | - |
| Capital Lease Obligations | 248 | 237 | 11 | - | - |
| Facility Leases | 41,150 | 7,491 | 13,205 | 8,719 | 11,735 |
| Service Agreements – Bandwidth | 4,708 | 2,630 | 1,526 | 552 | - |
| Other Commitment – Software license | 4,159 | 2,613 | 1,546 | - | - |
| Total Contractual Obligations | 109,295 | 17,979 | 29,642 | 49,939 | 11,735 |

(a) On November 9, 2010, the Company entered into credit agreement (the "CA") with National Bank of Canada as Agent (the "Agent") under which the Agent and other lenders (the "Lenders") agreed to provide the Company with two credit facilities (the "Facilities") a revolving facility (the "Revolving Facility") for a term of five years, for up to $30,000,000 (or the Canadian dollar equivalent) and a non-revolving facility (the "Non-Revolving Facility") for a term of five years for up to $45,000,000 (or the Canadian equivalent). Loans ("Loans") made under either Facility may be, at the Company's option, made in Canadian dollars pursuant to Prime Rate Loans or Banker's Acceptances or in US dollars pursuant to US Base Rate Loans or LIBO Rate Loans, all as defined in the CA. In addition, Letters of Credit in either Canadian or US dollars are available under the Revolving Facility. At the Company's option, the Company can convert Loans from one type to another. Both Facilities mature five years after the closing date which is expected to be several weeks following November 9, 2010. The Revolving Facility has an accordion feature (the "Accordion Feature"), which subject to credit approval, allows the Company to borrow up to an additional $25,000,000. The Accordion Feature must be drawn in multiples of $5,000,000 and is available to be drawn down up to 90 days preceding the Maturity Date. Repayment terms of the Accordion Feature are the same of those under the Revolving Facility.

## OFF-BALANCE SHEET ARRANGEMENTS

As at June 30, 2011, PEER 1 Hosting has provided a letter of credit totaling $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 as part of the financial statement caption, other assets.

The Company has also provided a letter of credit totaling CDN$0.14 million as security to a landlord for a facility lease. The security for the facility lease will be required to coincide with the term of a contract with a primary customer in the same facility. There is no collateral required under this letter of credit.

## TRANSACTIONS WITH RELATED PARTIES

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

The significant transactions with related parties are as follows:

| | | 2011 | | 2010 |
|---|---|---|---|---|
| Transactions during the year: | | | | |
| Revenue earned from companies owned or subject to significant influence by directors and principal shareholders | **$** | **141** | $ | 128 |
| Other expenses from companies owned or subject to significant influence by directors and principal shareholders | **$** | **1** | $ | 1 |

These transactions are in the normal course of operations and are measured at their exchange amounts, which is the amount of consideration established and agreed to by the related parties.

| | | 2011 | | 2010 |
|---|---|---|---|---|
| Balances at the end of the year: | | | | |
| Accounts receivable from companies owned or subject to significant influence by directors and principal shareholders | $ | **-** | $ | - |

The balances are payable on demand and have arisen from the sale of products, provision of services and invoice payments.

## SUMMARY OF QUARTERLY RESULTS

The following table sets forth selected financial information for PEER 1 Hosting for the periods indicated. The information is derived from and should be read in conjunction with, and is qualified in its entirety by reference to, PEER 1 Hosting's audited and interim financial statements.

| | Three months ended (in thousands of United States dollars) | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | 30-Sep 2009 | 31-Dec 2009 | 31-Mar 2010 | 30-Jun 2010 | 30-Sep 2010 | 31-Dec 2010 | 31-Mar 2011 | 30-Jun 2011 |
| Revenue | 23,374 | 23,896 | 25,066 | 25,586 | 26,328 | 27,885 | 28,729 | 29,876 |
| Operating income | 2,478 | 2,259 | 2,167 | 535 | 1,207 | 1,261 | 422 | 1,239 |
| Net Income (loss) | 1,267 | 886 | 459 | (371) | 356 | (172) | (1,311) | 18 |
| Basic earnings (loss) per share | 0.01 | 0.01 | 0.00 | 0.00 | 0.00 | (0.00) | (0.01) | 0.00 |
| Fully diluted earnings (loss) per share | 0.01 | 0.01 | 0.00 | 0.00 | 0.00 | (0.00) | (0.01) | 0.00 |

### Fourth Quarter Results

| | Three months ended June 30, | | | |
|---|---|---|---|---|
| | **2011** | **%** | **2010** | **%** |
| Revenue: | | | | |
| Colocation | $ 4,279 | 14% | $ 3,491 | 14% |
| Bandwidth | 2,226 | 7% | 2,261 | 10% |
| Services | 1,679 | 6% | 1,383 | 4% |
| Colocation services | 8,184 | 27% | 7,135 | 28% |
| Hosting services | 21,692 | 73% | 18,451 | 72% |
| **Total revenue** | **$ 29,876** | **100%** | **$ 25,586** | **100%** |

### Revenue

Revenue increased to $29.88 million for the three months ended June 30, 2011 from $25.59 million for the three months ended June 30, 2010. The increase is primarily attributable to organic growth and the increase in value of the Canadian dollar against the US dollar.

The increase in revenue for the three months ended June 30, 2011 compared to the three months ended June 30, 2010 as a result of the increase in value of Canadian dollar denominated sales totaled $0.32 million. When adjusted for the exchange rates in effect in the prior year period, revenue for the three months ended June 30, 2011 was $29.55 million. Taking into account the effect of the differing exchange rates between the Canadian and US dollars for the comparative period, revenue increased by 15.5% for the three months ended June 30, 2011.

Colocation revenues increased to $4.28 million in the three months ended June 30, 2011 from $3.49 million for the three months ended June 30, 2010. The increase is primarily attributable to the increase in value of the Canadian dollar against the US dollar and organic growth. The effect on revenue of the increase in value of the Canadian dollar against the US dollar was $0.21 million for the three month periods ended June 30, 2011.

Bandwidth revenues decreased to $2.23 million for the three months ended June 30, 2011 compared to $2.26 million for the three months ended June 30, 2010. The decrease in bandwidth revenue is primarily attributable to pricing pressure in the market partly offset by the increased value of the Canadian dollar against the US dollar. The effect on revenue of the increase in value of the Canadian dollar against the US dollar was $0.12 million for the three months ended June 30, 2011.

Hosting Services revenues increased to $21.69 million for the three months ended June 30, 2011 from $18.45 million for the three months ended June 30, 2010 due to organic growth.

### Cost of Sales

Consolidated cost of sales increased to $18.48 million for the three months ended June 30, 2011 from $16.15 million for the three months ended June 30, 2010. Cost of sales as a percentage of revenue decreased to 61.85% for the three months ended June 30, 2011 from 63.12% for the three months ended June 30, 2010. During the three months ended June 30, 2011, the Company incurred costs $1.23 million related to its UK expansion which are included in cost of sales.

The increase in cost of sales compared to the same period in the prior year is primarily due to increased depreciation costs of $1.23 million, increased power costs of $0.44 million, increased software license costs of $0.42 million, and increased rent costs of $0.36 million, partly offset by lower staff cost of $0.35 million. Revenue increased 16.77% for the three months ended June 30, 2011, compared to the three months ended June 30, 2010 while cost of sales increased 14.42% in the same period.

### 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 June 30, | | | |
|---|---|---|---|---|
| (in thousands $) | **2011** | **%** | **2010** | **%** |
| Total operating expenses | $10,158 | 34.00% | $ 8,902 | 34.79% |

Total operating expenses increased to $10.16 million for the three months ended June 30, 2011 from $8.90 million for the three months ended June 30, 2010. Operating expenses as a percentage of revenue was 34% for the three months ended June 30, 2011 and 34.79% for the three months ended June 30, 2010.

The increase in total operating expenses for the three months ended June 30, 2011 is primarily due to higher staff and training costs of $0.87 million, higher amortization expense of $0.29 million, higher sales commissions of $0.18 million, higher expense for professional services of $0.12 million, partly offset by lower travel expense of $0.16 million, and lower bad debt expense of $0.01 million. Total operating expense for the quarter ended June 30, 2011 is comprised of $4.52 million (2010: $3.88 million) sales and marketing expenses, $4.41 million (2010: $4.11 million) general and administrative expenses, and $1.22 million (2010: $0.91 million) expenses in technology and customer relations. During the three months ended June 30, 2011, the company incurred expenses of $1.03 million related to its UK expansion which are included in operating expenses, $0.28 million of which are categorized as general and administrative expenses and $0.74 million of which are categorized as selling and advertising expenses.

### Interest Expense

Interest expense increased to $0.81 million for the three months ended June 30, 2011 compared to $0.35 million for the three months ended June 30, 2010 primarily due to higher debt during the quarter ended June 30, 2011.

### Income Tax Expense

For the three months ended June 30, 2011, PEER 1 Hosting recorded total income tax expense of $0.51 million.

### Liquidity and Capital Resources

Cash and cash equivalents for the three months ended June 30, 2011 decreased by $15.7 million compared to a decrease of $1.38 million in the same period in the prior year and was primarily due to higher capital expenditures and payment of notes payable, partly offset by higher net income and higher amortization expense. Cash outflow from investing activities was $17.41 million compared to $7.34 million in the prior year as a result of increased cash outflow from capital expenditures during the quarter.

## OUTSTANDING SHARE DATA

PEER 1 Hosting has authorized share capital of unlimited common shares without par value and unlimited preferred shares without par value. At June 30, 2011, 120,576,570 common shares were issued and outstanding. Subsequent to June 30, 2011 and as at the date of the MD&A, nil common shares of the company were repurchased and cancelled. As of the date of this MD&A, 120,647,028 common shares were issued and outstanding.

At June 30, 2011, there are no warrants outstanding. At June 30, 2011, 18,551,889 stock options were outstanding. Subsequent to the year ended June 30, 2011 and as of the date of this MD&A, 150,000 options were exercised and 13,067 options were forfeited and nil additional options have been granted. Stock options outstanding as of the date of this MD&A are 18,388,822.

If all options were exercised there would be a total of 139,035,850 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 and the likelihood of M&A projects being completed.

In estimating the allowance for doubtful accounts, management reviews the payment history of current customers as well as overall historical collection trends.

Estimates as to the useful life of fixed assets are based upon industry experience.

Valuation of the options and warrants is based on estimates of dividend yield (nil), expected volatility of the PEER 1 Hosting 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.

## CONTROLS AND PROCEDURES

Disclosure controls and procedures are designed to provide reasonable assurance that all relevant information is gathered and reported to senior management, including the Chief Executive Officer (CEO) the Executive Vice President and Chief Financial Officer (CFO), on a timely basis so that appropriate decisions can be made regarding public disclosure. The CEO and the CFO have evaluated the effectiveness of the Company's disclosure controls and procedures related to the preparation of Management's discussion and analysis and the Consolidated financial statements. They have concluded that the Company's disclosure controls and procedures were effective, at a reasonable assurance level, to ensure that material information relating to the Company and its consolidated subsidiaries would be made known to them by others within those entities, particularly during the period in which the Management's discussion and analysis and the Consolidated financial statements contained in this report were being prepared. Internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements in accordance with Canadian GAAP. The Company's CEO and CFO have assessed the effectiveness of the Company's internal control over financial reporting as at June 30, 2011 in accordance with Internal Control – Integrated Framework, issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on this assessment, the Company's CEO and CFO have determined that the Company's internal control over financial reporting is effective as at June 30, 2011. There were no changes in internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

## RECENT ACCOUNTING PRONOUNCEMENTS

The Company will commence reporting under IFRS in the first quarter of fiscal 2012 with comparative figures for the transitional period.

The Company has conducted a detailed analysis of relevant IFRS standards and has made assessments with respect to available exemptions that are expected to be used by the Company, which could result in impacts on adoption of IFRS as noted below.

| Exemptions | Application of Exemption |
|---|---|
| Business Combinations (IFRS 3) | This Company expects to elect this exemption and not restate any business combinations that occurred prior to July 1, 2010. |
| The Effects of Changes in Foreign Exchange Rates (IAS 21) | The Company expects to elect this exemption and reset all cumulative translation gains and losses to zero in opening retained earnings at July 1, 2010. |
| Share Based Payment (IFRS 2) | The Company expects to elect to not apply IFRS 2 to awards that vested prior to July 1, 2010. |
| | |
| Borrowing Costs (IAS 23) | The Company expects to elect the transitional provisions of IAS23 and commence capitalizing borrowing costs on a prospective basis from the date of transition to IFRS. |

The Company continues the process of quantifying the expected material differences between IFRS and the current accounting treatment under Canadian GAAP.  A listing of differences identified with respect to recognition, measurement, presentation and disclosure of financial information that is expected to be in the following key account areas is noted below.

| Key Accounting Area | Differences with Potential Impact to the Company |
|---|---|
| Presentation of Financial Statements (IAS 1) | Additional disclosures in the notes to the financial statements. |
| Leases (IAS 17) | Adjust the deferred gain on sale and leaseback transactions. This will result in a positive impact of $0.3 million on opening retained earnings. |
| The Effects of Changes in Foreign Exchange Rates (IAS 21) | The Company has assessed the functional currency of the parent company and subsidiary companies under IFRS. This will result in a change in functional currency as well as a change in the manner foreign operations are consolidated into the group financial statements. These changes primarily affect the carrying value of non-monetary assets. |
| Financial Instruments: Recognition and Measurement (IAS 39) | The Company has only applied hedge accounting in the opening statement of financial position where all the requirements for hedge accounting in IAS 39 were met at the date of transition. Where the requirements of IAS39 were not met, the Company will adjust the hedge accounting previously recorded under Canadian GAAP. Accordingly a reduction to retained earnings of $0.34 million will be recorded. |

The following are some of the key activities that have been performed and their current status:
The Company is in the process of assessing the impact of IFRS on its financial statement presentation and disclosure. These assessments will need to be further analyzed and evaluated, however we continue to be on track with our original timetable to implement this as part of the transition project. Initial draft financial statements have been prepared internally and are currently in the process of being reviewed by management.

*Control activities: Internal control over financial reporting*
Management continues to assess the changes necessitated to maintain the integrity of internal control over financial reporting. The required accounting process changes that result from the application of IFRS accounting policies are not significant. The Company is in the process of updating the documentation of the internal controls over accounting process changes that will result from the application of IFRS accounting policies.

*Control activities: Disclosure controls and procedures*
All accounting policy changes from the transition to IFRS and the corresponding adjustments to the financial statements are subject to review by senior management and approval by the audit committee of the board of directors. These are currently being reviewed internally before being finalized.

The impact of transitioning to IFRS has not had a significant impact on the Company's information systems and management continues to implement changes for an efficient conversion to IFRS.

The Company continues with various levels of training for key personnel in both financial and operating capacities.

## 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.

In January 2009, the CICA issued Section 1582, "Business Combinations", which replaces former guidance on business combinations. Section 1582 establishes principles and requirements of the acquisition method for business combination and related disclosures. The Section applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after January 1, 2011 with earlier adoption permitted. The adoption of this standard has not had an impact on the Company's financial statements.

In January 2009, the CICA issued Handbook Section 1601, "Consolidated Financial Statements", which replaces the existing standard. This Section carries forward existing Canadian guidance for preparing consolidated financial statements other than non-controlling interests. The Section is effective for interim and annual financial statements beginning on January 1, 2011 and earlier adoption is permitted. . The adoption of this standard has not had an impact on the Company's financial statements.

In January 2009, the CICA issued Section 1602, "Non-controlling Interests", which replaces existing guidance. Section 1602 provides guidance on accounting for a non-controlling interest in a subsidiary in consolidated financial statements subsequent to a business combination. These standards are effective on or after the beginning of the first annual reporting period on or after January 1, 2011 with earlier adoption permitted. As of June 30, 2011 the Company has no non-controlling interests, and accordingly there is no currently expected impact as a result of the standard.

### Financial Instruments and Other Instruments

*Financial Instruments*
Financial instruments are classified into one of these five categories: held-for-trading, held-to-maturity, 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 (OCI) until the investment is derecognized or impaired at which time the amounts would be recorded in net income.

The Company has designated its cash, cash equivalents, restricted cash and derivative financial instruments as held-for-trading, which are measured at fair value. Accounts receivable and security deposit are classified as loans and receivables, which are measured at amortized cost. Accounts payable, accrued liabilities, obligations under capital lease and notes payable are classified as other financial liabilities. The Company had neither available-for-sale, nor held-to-maturity instruments during the year ended June 30, 2011.

*Derivative Financial Instruments*
The Company uses derivative financial instruments in the management of its interest rate exposure and foreign exchange risk. The Company's policy is not to use derivative financial instruments for trading or speculative purposes.

*Determination of Fair Value*
The fair value of a financial instrument is the amount of consideration that would be agreed upon in an arm's length transaction between knowledgeable willing parties who are under no compulsion to act. The fair value of a financial instrument on initial recognition is the transaction price, which is the fair value of the consideration given or received. Subsequent to initial recognition, the fair values of financial instruments that are quoted in active markets are based on bid prices for financial assets held and offer prices for financial liabilities. When independent prices are not available, fair values are determined by using valuation techniques which refer to observable market data. These include comparisons with similar instruments where observable market prices exist, discounted cash flow analyses, option pricing models and other valuation techniques commonly used by market participants. For certain derivatives, fair values may be determined in whole or in part from valuation techniques using non-observable market data or transaction prices. A number of factors such as bid-offer spread, credit profile and model uncertainty are taken into account, as appropriate, when values are calculated using valuations techniques.

*Hedges*
When the Company uses derivatives in hedge accounting relationships, the Company formally documents all relationships between hedging instruments and hedged item, as well as its risk management objective and strategy for undertaking various hedge transactions. This process includes linking derivatives to specific assets and liabilities on the balance sheet or to specific firm commitments or forecasted transactions. The Company also assesses whether the derivatives that are used in hedging transactions are effective in offsetting changes in fair values or cash flows of hedged items. When hedging instruments become ineffective before their maturity or the hedging relationship

is terminated, deferred gains or losses on such instruments are charged to earnings in the same period as the corresponding gains or losses for the hedged items; gains and losses or gains realized subsequently as a result of marking to market are charged directly to earnings. If the hedged item ceases to exist due to its maturity, expiry, cancellation or exercise before the hedging instrument expires, deferred gains or losses are charged to earnings.

Derivative financial instruments are classified as held for trading, unless they are designated as hedging instruments for which hedge accounting is applied.

Derivative financial instruments are classified as held for trading. The Company may choose to designate derivative financial instruments as hedging instruments for which hedge accounting is applied (see below).

During the year ended June 30, 2011, the Company entered into two swap agreements which were put into place to manage interest risk associated with outstanding balances on the non-revolving facility. The use of these two swaps with a five-year term provides the Company with a blended rate of 2.472% plus applicable margin: CDN$14 million is at 2.925% plus applicable margin, and USD$30 million at 2.260% plus applicable margin.

The Company has designated its two existing interest-rate swap agreements as cash flow hedges. As at June 30, 2011, the total fair value of these swaps was $1.12 million. In a cash flow hedge relationship, the portion of gains or losses on the hedging item that is determined to be an effective hedge is recognized in OCI, while the ineffective portion is recorded in net income. The amounts recognized in OCI are reclassified in net income when the hedged item affects net income. Hedge accounting is discontinued prospectively when it is determined that the hedging instrument is no longer effective as a hedge, the hedging instrument is terminated or sold, or upon the sale or early termination of the hedged item. As at June 30, 2011, the hedge has been determined to be effective.

## RISK FACTORS

The Company and its shareholders are subject to the following risks, in addition to the risks mentioned elsewhere in this Management’s Discussion and Analysis.

### Future Capital Needs

The Company may require additional working capital in the future to finance the ongoing operation, development and expansion of the Company’s 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 the Company’s competitors have longer operating histories, significantly greater financial, technical, marketing and other resources, greater brand recognition, and, PEER 1 Hosting believes, a larger customer base. In addition, competitors may operate more successfully than PEER 1 Hosting or form alliances to acquire significant market share from the Company. 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 Hosting and there can be no assurance that the Company's competitors will not be able to develop services comparable or superior to those offered by PEER 1 Hosting at more competitive prices. As a result, in the future the Company may suffer from an inability to offer competitive services or be subject to negative pricing pressure that would adversely affect the Company's 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 the Company 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 the Company's 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 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 History of Profitability**

Although the Company commenced operations in 1999, it has only operated profitably periodically since 2007, and there can be no further assurances that the Company will be profitable.

**Loan Facilities**

The Company has entered into a Credit Agreement and has granted general security over all of its assets to its Lender. Pursuant to the Credit Agreement, the Company has a number of continuing obligations and covenants including covenants of repayment of the credit facilities. Although the Company is currently in compliance with its obligations and covenants under the Credit Agreement, in the event of a breach, the Company would be in default and the lender could be in a position to realize on the Company's assets if the Company is not in a position to repay its outstanding indebtedness.

**Dependence on Personnel**

The Company's continued success is largely dependent on the personal efforts and abilities of its senior management. The Company's success also depends on the Company's 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.

## Management of Growth

In the past year, the Company commenced the first of a four POD (Performance Optimized Data Center) design build out on a 50,000 square foot data center located in Portsmouth, UK and completed the build out of two additional PODs at our flagship datacenter in the greater Toronto area. This expansion is required in order to maintain and extend its position in the market. Expansions place pressure on our 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, our growth objectives will be prejudiced and our business, financial condition and results of operations will be adversely impacted.

## Risk of Damage to the Company's 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, the Company's revenue could decline and its existing and prospective customers may lose confidence in the Company's systems. The Company could also be required to make significant expenditures if the Company's systems were damaged or destroyed, or pay damages if the delivery of the Company's 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, the Company 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 the customers' 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 the Company's 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, the Company 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 the Company's 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, the U.S. Northeast in 2003, and in downtown Vancouver in 2008, natural disasters such as the tornados on the U.S. East Coast in 2004 and limitations on availability of adequate power resources. Power outages can harm, and in the past, have harmed the Company’s customers and its business, including the loss of customers' data and extended service interruptions. While the Company attempts to limit exposure to system downtime by using backup generators and power supplies, the Company cannot limit the Company’s 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 the Company’s customers which could have a material adverse effect on the Company’s 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 the Company’s services and solutions. The Company has contractual obligations to provide service level credits to almost all of the Company’s customers against future invoices if certain service disruptions occur. Although the Company’s service agreements limit the Company’s 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 the Company’s 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 the Company’s current policies.

## Economic Profile of Customer Base

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 service, or are 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 provide, which would negatively affect the overall demand for the Company’s services and could cause the Company’s revenue to decline.

## Leased Data Center 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 the Company’s 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. As at June 30, 2011, revenue generated from the Company’s largest leased data center represented approximately 20.32% of the Company’s consolidated revenues.

## Reliance on Third Parties

The Company purchases bandwidth from, or enters 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 the Company on 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 IP backbone networks, then the Company's operating results may have a material adverse effect.

## Regulatory Developments

The Company operates in a largely unregulated environment. 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 the Company's 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 the Company's 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 the Company's services and solutions, and this could materially adversely affect the Company's 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 the Company. Even in the absence of such breaches, the Company's trade secrets and proprietary know-how may otherwise become known to the Company's competitors, or be independently discovered by the Company's competitors, which could adversely affect the Company's 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 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.

## Excess Capacity

The Company has excess capacity in some of its data centers and the Company is in the process of adding additional capacity in certain geographies where the Company faces capacity constraints. There can be no assurance that the Company will be able to fill this capacity. Any failure in this regard may have a material adverse effect on the Company's business, results of operation and financial condition.

## 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 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.

## Share Price Volatility

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

## Controlling Shareholders

The Company understands, based on the content of early warning reports (the "Early Warning Reports"), as amended, that are available for viewing under the Company's profile at www.sedar.com, that Clairvest Equity Partners III Limited Partnership and CEP III Co-Investment Limited Partnership (together "Clairvest") have entered into a shareholders agreement (the "Shareholders Agreement") with Messrs. Lance Tracey, Scott Shaw, Tom Paulus and Werner Paulus, each a director of PEER 1 Hosting, and certain of their respective associates and affiliates (each group referred to as a "Major Shareholder" and collectively, together with Clairvest, referred to as the "Major Shareholder Group"). Pursuant to the Shareholders Agreement, each Major Shareholder has agreed to cause the election to the Company's Board two directors designated by Clairvest, two designated by the Paulus Group, the Penfield Group and the Padilla Group, and two designated by the Sutton Group, as those terms are defined in the referenced Early Warning Reports. See the Early Warning Reports at www.sedar.com for more information on the terms of the Shareholders Agreement.

As of August 31, 2011, to the best of the knowledge of PEER 1, the Major Shareholder Group exercises control or direction, directly or indirectly, over approximately 77,431,606 of our common shares, representing approximately 64.2% of our outstanding common shares. As such, the Major Shareholder Group has the ability to determine the outcome of matters submitted to shareholders for approval, including the election and removal of directors, amendments to our corporate governing documents and business combinations. Our interests and those of our controlling shareholders may at times conflict, and this conflict might be resolved against our interests. The concentration of control in the hands of a small number of individuals may practically preclude an unsolicited bid for our shares, and this may adversely impact the value and trading price of our shares.

## Future Sales by Significant Shareholders

If any member of the Major Shareholder Group sells the Company's common shares, the market price of the common shares may fall. This could result from the pressure on the market caused by such sales, or from concern that the sales signify problems in the Company's operations, or from some combination of the two factors. Mitigating this risk to some extent, though in no way eliminating it, is the fact that the Early Warning Reports say that the Shareholders Agreement restricts members of the Major Shareholder Group from selling shares, subject to certain exceptions; and it provides that a

Major Shareholder wishing to sell common shares must first offer to sell to the other Major Shareholders. See the Early Warning Report at www.sedar.com.

## OTHER INFORMATION

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