



THREE MONTHS ENDED SEPTEMBER 30, 2010 AND 2009  
**MANAGEMENT'S DISCUSSION & ANALYSIS**

**MANAGEMENT'S DISCUSSION AND ANALYSIS  
OF FINANCIAL RESULTS  
FOR THE THREE MONTHS ENDED SEPTEMBER 30, 2010**

*This Management Discussion and Analysis ("MD&A") of Peer 1 Network Enterprises, Inc. ("PEER 1 Hosting" or "the Company"), dated November 10, 2010, should be read in conjunction with PEER 1 Hosting's unaudited first quarter financial statements, as well as the audited annual financial statements for the fiscal year ended June 30, 2010 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**

A deterioration in economic conditions, such as occurred in the past two 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**

### **Quarterly Financial Highlights**

- PEER 1 Hosting's revenue increased 12.64% to \$26.33 million for the three months ended September 30, 2010, compared to \$23.37 million for the three months ended September 30, 2009. 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 11.54%.
- Gross profit increased 4.22% to \$10.07 million for the three months ended September 30, 2010, compared to \$9.66 million for the three months ended September 30, 2009.
- Operating income decreased 51.31% to \$1.21 million for the three months ended September 30, 2010, compared to \$2.48 million for the three months ended September 30, 2009.
- Income before income taxes was \$0.93 million for the three months ended September 30, 2010, compared to \$2.20 million for the three months ended September 30, 2009.
- Net income was \$0.36 million for the three months ended September 30, 2010, compared to \$1.27 million for the three months ended September 30, 2009.

### **Quarterly Developments**

- 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.
- Announced its participation in the VMware Service Provider Program ("VSPP") to offer customers Private Cloud solutions. VMware 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.
- Completed two independent audits of its selected controls, processes and procedures in compliance with the American Institute of Certified Public Accountants' ("AICPA") Statement on Auditing Standards (SAS) No. 70 for service organizations and the Canadian Institute of Chartered Accountants (CICA) Section 5970. These audits covered the period from January 1, 2010 to June 30, 2010 and are commonly referred to within the hosting industry as a Type II Audit.

- Announced that IBM Canada is a PEER 1 Hosting platinum level colocation reseller.
- Launched the PEER 1 Hosting Partner Directory, subsequent to the end of the quarter, enabling existing PEER 1 Hosting partners to connect and build relationships with potential customers using the directory database.

## **THE BUSINESS**

PEER 1 Hosting is a premier Internet infrastructure provider, delivering managed, dedicated, colocation and network services through 17 datacenters 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 YouTube, Facebook, MySpace or Twitter 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.

PEER 1 Hosting 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 Hosting.

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, 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 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 vulnerability scanning services to satisfy customer demands for 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 datacenters.
- 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.

## **DEDICATED HOSTING**

Dedicated 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 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.

## **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 datacenters 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 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. The Company's senior management team and Board of Directors have considerable acquisition experience and have completed and integrated two major acquisitions during the past five years.

## SELECTED QUARTERLY 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 unaudited financial statements for the three months ended September 30, 2010.

	September 30, 2010	September 30, 2009
Revenue		
Colocation Services	\$ 7,093	\$ 6,628
Hosting Services	19,235	16,746
	<b>26,328</b>	23,374
Cost of revenue	<b>16,257</b>	13,711
Gross profit	<b>10,071</b>	9,663
Operating expenses	<b>8,864</b>	7,185
Operating income before other items	<b>1,207</b>	2,478
Other items:		
Interest income	(13)	(4)
Gain on insurance recovery	-	(93)
Gain on disposal of property and equipment	(16)	(12)
Foreign exchange loss (gain)	(53)	80
Interest expense – long term	364	313
	<b>282</b>	284
Income before income taxes	<b>925</b>	2,194
Future income tax expense (recovery)	(371)	(297)
Current income tax expense	<b>940</b>	1,224
Income tax expense	<b>569</b>	927
<b>Net income</b>	<b>\$ 356</b>	<b>\$ 1,267</b>
Other comprehensive income:		
Change in unrealized fair value of derivatives designated as cash flow hedges	(11)	(82)
<b>Comprehensive income</b>	<b>\$ 345</b>	<b>\$ 1,185</b>
Net income attributable to:		
Common shares	<b>\$ 356</b>	<b>\$ 1,267</b>
Comprehensive income attributable to:		
Common shares	<b>345</b>	<b>1,185</b>
Basic and diluted earnings per share	<b>\$ 0.00</b>	<b>\$ 0.01</b>
Weighted average number of shares outstanding:		
Basic	<b>119,733,661</b>	119,508,564
Diluted	<b>120,728,588</b>	123,296,839

## 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. Customer contracts range from month-to-month to five-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 configuration and installation.

	Three months ended September 30,			
	2010	%	2009	%
Revenue:				
Colocation	3,477	13%	3,313	14%
Bandwidth	2,192	8%	2,019	9%
Services	1,424	6%	1,296	6%
Colocation services	7,093	27%	6,628	29%
Hosting services	19,235	73%	16,746	71%
<b>Total revenue</b>	<b>\$ 26,328</b>	<b>100%</b>	<b>\$ 23,374</b>	<b>100%</b>

Revenue increased to \$26.33 million for the three months ended September 30, 2010 from \$23.37 million for the three months ended September 30, 2009. 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 Net.Works USA, Inc. ("VIA") acquisition. When adjusted for the exchange rates in effect during the period, revenue for the three months ended September 30, 2010 was \$26.07 million. Taking into account the effect of the differing exchange rates between the Canadian and US dollars for the comparative period, revenue increased by 11.54% for the three months ended September 30, 2010.

Colocation revenue increased to \$3.48 million three months ended September 30, 2010 compared with \$3.31 million for the three months ended September 30, 2009. The increases in colocation revenue are attributable to organic growth as well as the increase in the value of the Canadian dollar against the US dollar. PEER 1 Hosting's efforts to secure additional data centre space are ongoing. The effect on revenue from the increase in value of the Canadian dollar against the US dollar was \$0.17 million for the three months ended September 30, 2010.

Bandwidth revenue increased to \$2.19 million for the three months ended September 30, 2010 compared with \$2.02 million for the three months ended September 30, 2009. The increase in revenue is primarily attributable to the increased value of the Canadian dollar 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 \$0.09 million for the three months ended September 30, 2010.

Hosting Services revenues increased to \$19.24 million for the three months ended September 30, 2010 from \$16.75 million for the three months ended September 30, 2009. The increase for the three months ended September 30, 2010 is attributable to organic growth and additional revenue from the

VIA acquisition. 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 \$5.48 million of revenue for the three months ended September 30, 2010 compared with \$4.73 million of revenues for the three months ended September 30, 2009. This change is primarily related to organic growth and favorable foreign exchange effects of \$0.26 million for the three months ended September 30, 2010. 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 \$2.55 million for the three months ended September 30, 2010 from \$13.71 million for the three months ended September 30, 2009. During the three months ended September 30, 2010, the Company incurred costs \$0.83 million related to its UK expansion which are included in cost of sales. Cost of sales as a percentage of revenue increased to 61.75% for the three months ended September 30, 2010 from 58.66% for the three months ended September 30, 2009.

The increase in cost of sales for the three months ended September 30, 2010 compared to the same period in the prior year is primarily due to increased staff costs of \$0.19 million, increased depreciation costs of \$1.05 million, increased software license costs of \$0.11 million, increased power costs of \$0.37 million, increased repairs and maintenance costs of \$0.17 million, increased bandwidth costs of \$0.17 million and increased rent costs of \$0.54 million associated with data center expansion in the UK and Toronto.

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.

(in thousands \$)	Three months ended September 30,			
	2010	%	2009	%
Total operating expenses	\$ 8,864	33.67%	\$ 7,185	30.74%

Total operating expenses increased \$1.68 million to \$8.84 million for the three months ended September 30, 2010 from \$7.14 million for the three months ended September 30, 2009. Operating expenses as a percentage of revenue increased to 33.67% for the three months ended September 30, 2010 from 30.74% for the three months ended September 30, 2009. The increase in operating expenses for the three months ended September 30, 2010 is largely attributable to \$0.84 million higher staff and training cost, increased commission expenses of \$0.32 million attributable to new sales, increased professional services of \$0.39 million, increased rent of \$0.05 million, increased office expenses of \$0.06 million, increased property tax of \$0.04 million, increased travel expenses of \$0.03 million, increased insurance expenses of \$0.02 million and \$0.54 million higher advertising expenses offset in part by \$0.16 million lower amortization, \$0.05 million in decreased bad debt expense and lower stock based compensation of \$0.11 million. The decrease in bad debt expense reflects a lower estimated expense for doubtful accounts that is based on management's review of specific customer payment history, the age of the accounts receivable and collection trends. Total operating expense for the three months ended September 30, 2010 is comprised of \$3.95 million (2009: \$2.98 million) sales and marketing expenses, \$3.72 million (2009: \$3.52 million) general and administrative expenses, and \$1.19 million (2009: \$0.69 million) in expenses for Technology and Customer relations. During the three months ended September 30, 2010, the company incurred \$0.76 million related to its UK expansion which are included in operating expenses, \$0.29 million of which are categorized as general and administrative expenses and \$0.47 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 administration requirements.

### **Other Income and Expenses**

Interest income for the three months ended September 30, 2010 was \$0.01 million compared to \$0.004 million for the three months ended September 30, 2009.

### **Interest Expense**

Interest expense increased to \$0.36 million for the three months ended September 30, 2010 compared to \$0.31 million for the three months ended September 30, 2009 primarily due to additional line of credit utilization under Facility A.

### **Income Tax Expense**

For the three months ended September 30, 2010, PEER 1 Hosting recorded total income tax expense of \$0.57 million compared to \$0.93 million for the three months ended September 30, 2009.

The Company's effective tax rate of 61.53% for the three months ended September 30, 2010 differs from the combined federal, provincial and state tax rates in part due to the effect of non-deductible expenses related to stock based compensation.

## Financial Position

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

(in millions of US dollars)	Increase / (Decrease)	Explanation
Cash and cash equivalents	\$ 0.04	Refer to Statement of Cash Flows and liquidity and capital resources discussion.
Accounts receivable	(0.03)	Normal fluctuations from billing and collections cycles.
Prepaid expenses	1.89	Normal fluctuations from operations. Net prepayment of software licences of \$1.69 million
Income tax receivable / payable	1.07	Payments of income taxes.
Property and equipment	2.47	Includes \$3.42 million related to dedicated servers, \$3.17 million related to data center and network equipment, less depreciation.
Equipment under capital lease	(0.07)	Depreciation
Intangible assets	0.20	In-house and purchased software.
Accounts payable and accrued liabilities	0.08	Accounts payable payment cycle.
Notes payable	5.31	\$6 million drawdown of Line of Credit partly offset by principal repayment, and amortization of loan origination fees.
Share capital	0.004	Stock options exercised, less share repurchase.
Contributed surplus	0.44	Value of stock-based compensation and stock options exercised.
Retained earnings	0.14	Year-to-date net income less \$0.21 million related to stock repurchase charged to retained earnings.
Accumulated other comprehensive income	(0.01)	Mark-to-market of cash flow hedge.

## Liquidity and Capital Resources

During the three months ended September 30, 2010, the Company has continued construction of a new data center in the greater Toronto area. During the quarter, the Company continued with its announced plans to proceed with the buildout of phases two and three at its flagship data center in the Greater Toronto Area at an expected capital cost of \$14.50 million.

During the three months ended September 30, 2010, the Company incurred capital expenditures related to this new data center facility in the amount of \$1.04 million of which \$0.53 million has been paid during the three months ended September 30, 2010.

PEER 1 Hosting has historically financed operations through cash generated from operations, sale of common and preferred shares and issuance of debt. As at September 30, 2010, the Company had

cash and cash equivalents of \$2.36 million compared to \$2.32 million as at June 30, 2010. The current portion of the Company's notes payable as at September 30, 2010 was \$3 million.

The Company had a working capital deficit of \$4.26 million at September 30, 2010 compared to working capital deficit of \$7.14 million as at June 30, 2010. The decrease in working capital deficit is primarily due to additional drawdown on the line of credit 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 September 30, 2010, the Company had available US\$11.86 million from its US\$25 million revolving credit facility.

### **Operating Activities**

Cash flow from operating activities for the three months ended September 30, 2010 and 2009 was \$0.44 million and \$1.96 million, respectively. The decrease in cash provided by operations for the three months ended September 30, 2010 resulted primarily from decreased net income, and higher prepaid expenses, decreased accounts payable partly offset by higher amortization expenses and less payment of income taxes.

### **Investing Activities**

Cash used for investing activities for the three months ended September 30, 2010 and 2009 was \$5.3 million and \$6.36 million, respectively. The decrease in use of cash for the three months ended September 30, 2010 compared to the three months ended September 30, 2009 is primarily a result of less acquisition of property and equipment, and expenditures on leasehold improvements during the quarter ended September 30, 2010.

### **Financing Activities**

Net cash inflows from financing activities for the three months ended September 30, 2010 was \$4.92 million compared to net cash inflows from financing of \$0.36 million for the three months ended September 30, 2009. The increase in cash inflow from financing activities for the three months ended September 30, 2010 compared to the three months ended September 30, 2009 is primarily due to proceeds from the drawdown under National Bank of Canada – Loan Facility A, partly offset by share repurchase and repayment of notes payable under Facility B. During the three months ended September 30, 2010, the company repurchased shares in connection with its normal course issuer bid. \$0.26 million of cash was used to repurchase the Company's own shares during this period. The Company believes that such purchases are in the best interest of PEER 1 shareholders and constitute an attractive investment opportunity and a desirable use of corporate funds that should enhance the value of remaining shares.

## OFF-BALANCE SHEET ARRANGEMENTS

As at September 30, 2010, PEER 1 Hosting has provided a 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 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.

During the three months ended September 30, 2010, transactions with related parties were as follows (in thousands \$):

	2010	2009
Revenues earned from companies owned or subject to significant influence by directors and principal shareholders	\$ 34	\$ 28
Other expenses incurred from companies owned or subject to significant influence by directors and principal shareholders	\$ -	\$ -

	2010	2009
Balances at the end of the period:		
Accounts receivable from companies owned or subject to significant influence by directors and principal shareholders	\$ -	\$ 170
Accounts payable from companies owned or subject to significant influence by directors and principal shareholders	\$ -	\$ -

These transactions are in the normal course of operations and are measured at their exchange amounts.

## 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)							
	31-Dec	31-Mar	30-Jun	30-Sep	31-Dec	31-Mar	30-Jun	30-Sep
	2008	2009	2009	2009	2009	2010	2010	2010
Revenue	23,640	22,649	22,516	23,374	23,896	25,066	25,586	26,328
Operating income	3,705	2,609	2,515	2,478	2,259	2,167	535	1,207
Net Income (loss)	2,005	1,414	577	1,267	886	459	(371)	356
Basic earnings (loss) per share	0.02	0.01	0.00	0.01	0.01	0.00	0.00	0.00
Fully diluted earnings (loss) per share	0.02	0.01	0.00	0.01	0.01	0.00	0.00	0.00

## SUBSEQUENT EVENTS

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 US\$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 US\$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 allows the Company to borrow up to an additional US\$25,000,000. The Accordion Feature must be drawn in multiples of US\$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.

Interest is payable on each Loan at the rate for that type of Loan plus a margin of 1.25% to 3.25% depending on the type of Loan and the Company's financial performance. Standby fees are payable on the portions of the Facilities that are not advanced of 0.6525% to 0.8125% depending on the Company's performance. In addition, there is an initial commitment fee of 0.7% of the Facilities, an initial arranger fee of 0.15% of the Facilities and an annual agency fee of CAD\$30,000. The Non-Revolving Facility will be permanently reduced by quarterly reductions with the first reduction to be made on December 31, 2011. For each 12-month period, the quarterly payments shall be in equal amounts and shall total; (1) for the 12-month period commencing on October 1, 2011, 15% of the principal amount of the outstanding Loans under the Non-Revolving Term Facility as at October 1,

2011, and (2) for each subsequent 12-month period, 15% of the principal amount of the outstanding Loans under the Non-Revolver Term Facility as at the last day of the Drawdown Period. The Company may permanently reduce the amount available under each Facility without penalty by an amount of not less than \$1,000,000 (US or Canadian dollars, as applicable). The Company may also cancel the Facilities and repay the Loans without penalty.

During the term of the Facilities the Company must meet certain financial conditions. The failure to meet such financial conditions will result in an event of default for which, among other things, the Agent may declare all outstanding Loans to be due and payable. The Facilities are secured by first ranking charges on all of the Company's presently held and after acquired property and on all of the presently held and after acquired property of its subsidiaries. In addition, all of the shares of its subsidiaries are pledged to the Agent and the Lenders as security for the Facilities.

The amounts advanced to the Company under the Loans are to be used for Distributions, working capital, financing Capital Expenditures and Investments, as defined in the CA.

## **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 September 30, 2010, 119,579,619 common shares were issued and outstanding. Subsequent to September 30, 2010 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, 119,642,119 common shares were issued and outstanding.

At September 30, 2010 and the date of this MD&A, 833,333 warrants for the purchase of shares at a price of CAD\$0.40 (approximately US\$0.39) were outstanding. At September 30, 2010, 18,653,300 stock options were outstanding. Subsequent to the three months ended September 30, 2010 and as of the date of this MD&A, 62,500 options were exercised, nil options expired, 21,667 options were forfeited and nil additional options have been granted. Stock options outstanding as of the date of this MD&A are 18,569,133.

If all warrants and options were exercised there would be a maximum of 139,044,585 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**

Management is responsible for the design of internal controls over financial reporting ("ICOFR") within the Company in order to provide reasonable assurance regarding the reliability of financial reporting and the preparation of the financial statements for external purposes in accordance with Canadian GAAP. The control framework used by management to design the Company's ICOFR is the Integrated Framework issued by the Committee of sponsoring Organisation of the Treadway Commission ("COSO"). Management has evaluated whether there were changes to its ICOFR during the three months ended September 30, 2010 that have materially affected, or are reasonably expected to materially affect, its ICOFR. No such changes were identified.

## **RECENT ACCOUNTING PRONOUNCEMENTS**

- i) In 2006, Canada's Accounting Standards Board announced that International Financial Reporting Standards ("IFRS") will replace Canadian GAAP for publicly accountable enterprises for financial periods beginning on or after January 1, 2011. The Company will commence reporting under IFRS in the first quarter of fiscal year 2012 with comparative figures for the transitional period.

The International Accounting Standards Board's work plan has projects underway that are expected to result in new pronouncements that continue to evolve IFRS. As a result, IFRS as at the transition date may be different from its current form.

The Company is in the process of assessing the impact of the convergence initiative and developing a plan for the implementation of IFRS. Such considerations include:

- Assessment of significant differences between Canadian GAAP and IFRS and their impacts on the Company's Consolidated Financial Statements.
- Identification, evaluation and selection of continuing IFRS policies.
- Evaluation of IT and financial systems' data capture and reporting functionality.
- Impact on disclosure controls and procedures, including changes in note disclosures, and communication with internal and external stakeholders.
- Identification of impact on internal control over financial reporting and training.
- Assessment of impact on other business activities such as compensation structure and financial covenants.

The Company has completed the initial impact assessment and scoping phase which utilizes a diagnostic approach to identify a modest number of topics that may impact either the Company's financial results or conversion efforts to IFRS. Detailed analyses of relevant and material standards and impact on the Company are currently being conducted. However, it is not practically possible at this time to quantify the impact of these differences. The Company expects to implement changes to processes and systems before the 2011 fiscal year to enable compliance and reporting under IFRS.

Training of key personnel identified to lead the transition effort continued during the current reporting period and the Company continues to engage the services of external consultants to assist with the comparative analysis between Canadian GAAP and IFRS and other technical elements. Continued progress is necessary before the Company can prudently develop a timeline schedule of major implementation activities and key deliverables.

The Company continues to progress with its IFRS conversion. As a result of work completed to date, the Company has made preliminary assessments with respect to available exemptions that are being considered by the Company, which could result in impacts on adoption of IFRS are as noted below. Further assessment of exemption options continues as work progresses.

<b>Exemptions</b>	<b>Application of Exemption</b>
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.
Property Plant and Equipment (IAS 16)	The Company does not expect to elect to revalue its assets to fair value and use it as deemed costs.
Borrowing Costs (IAS 23)	The Company expects to elect the transitional provision and commence capitalizing borrowing costs at the date of transition.

The Company continues the process of quantifying the expected material differences between IFRS and the current accounting treatment under Canadian GAAP. As a result of work completed to date, a preliminary listing of differences identified with respect to recognition, measurement, presentation and disclosure of financial information that are expected to be in the following key account areas is noted below. Further determination and quantification of areas

where there will be differences between IFRS and Canadian GAAP continue as IFRS implementation work progresses.

<b>Key Accounting Area</b>	<b>Differences with Potential Impact to the Company</b>
Presentation of Financial Statements (IAS 1)	<ul style="list-style-type: none"> <li>• Additional disclosures in the notes to the financial statements.</li> </ul>
Property Plant and Equipment (IAS 16)	<ul style="list-style-type: none"> <li>• Evaluating impact on review process for determination of residual value, depreciation and useful life.</li> <li>• Assess if the Company has any replacement parts or major inspections or overhauls that should be capitalized.</li> </ul>
Impairment of Assets (IAS 36)	<ul style="list-style-type: none"> <li>• Grouping of assets in cash-generating units (CGUs), determination of CGU based on the smallest identifiable group criterion, and using the expected cash flow approach to measure impairment.</li> <li>• Previous impairment taken is required to be monitored, tested, and possibly reversed at each reporting date.</li> <li>• Additional disclosure (ie. impairment losses and reversals).</li> </ul>
Leases (IAS 17)	<ul style="list-style-type: none"> <li>• Assess if there are any arrangements that meet the definition of a lease, with reconciling items on the first set of financial statements.</li> </ul>
Revenue (IAS 18)	<ul style="list-style-type: none"> <li>• The Company may immediately recognize installment fees since the installation process is simple in nature.</li> <li>• This would be an accounting policy change with retrospective adjustment required to opening retained earnings.</li> </ul>

- ii) 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 Company is currently evaluating the impact of this standard on its financial statements.
- iii) 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 Company is currently evaluating the impact of adopting this standard on its consolidated financial statements.
- iv) 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 September 30, 2010, the Company has no non-controlling interests, and accordingly there is no currently expected impact as a result of the standard.

- v) In June 2009, the CICA amended Handbook Section 3855, "Financial Instruments - Recognition and Measurement", to clarify the application of the effective interest method after a debt instrument has been impaired. The Section has also been amended to clarify when and embedded prepayment option is separated from its host instrument for accounting purposes. The amendments apply to interim and annual financial statements relating to fiscal years beginning on or after May 1, 2009 for the amendments relating to the effective interest method and January 1, 2011 for the amendment relating to embedded prepayment options. The Company is currently evaluating the impact of the amendments related to embedded prepayment options.

## **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.

### **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 three months ended September 30, 2010.

#### *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 continue to be deferred and charged to earnings in the same period as the corresponding gains or losses for the hedged items; gains and losses 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. The Company may choose to designate derivative financial instruments as hedging instruments for which hedge accounting is applied (see below).

The Company has designated its interest-rate swap agreement as a cash flow hedge. As at September 30, 2010, the value of this swap decreased by \$0.35 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.

## **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, fiscal 2010 marks only the Company's fourth year of profitable operations. There can be no assurance that the Company will continue to be profitable.

### **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 completed its largest data center expansion, located in the greater Toronto area. During this period the Company also expanded its operations in Europe by establishing an office and datacenter presence in the United Kingdom. Additional 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 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 September 30, 2010, revenue generated from the Company's largest leased data center represented approximately 21% 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](http://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 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](http://www.sedar.com) for more information on the terms of the Shareholders Agreement.

As of August 31, 2010, to the best of the knowledge of PEER 1 Hosting, the Major Shareholder Group exercises control or direction, directly or indirectly, over approximately 77,431,606 of the Company's common shares, representing approximately 64.7% of the Company's 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 the Company's corporate governing documents and business combinations. The Company's interests and those of the Company's controlling shareholders may at times conflict, and this conflict might be resolved against the Company's interests. The concentration of control in the hands of a small number of individuals may practically preclude an unsolicited bid for the Company's shares, and this may adversely impact the value and trading price of the Company's 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](http://www.sedar.com).

### **OTHER INFORMATION**

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