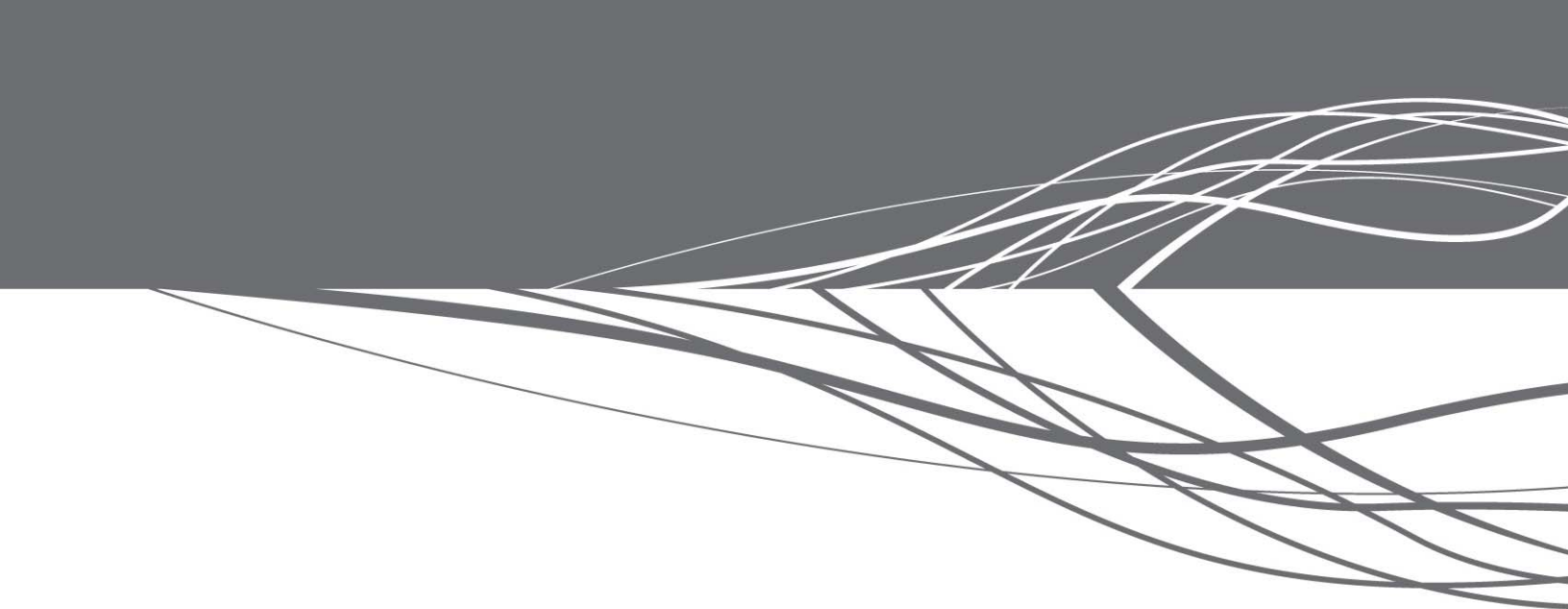


**peer1** | Fully scalable hosting solutions



**MANAGEMENT'S DISCUSSION AND ANALYSIS  
FOR THE FISCAL YEARS ENDED JUNE 30, 2009 AND 2008**

**MANAGEMENT'S DISCUSSION AND ANALYSIS  
OF FINANCIAL RESULTS  
FOR THE FISCAL YEAR ENDED JUNE 30, 2009**

*This Management Discussion and Analysis ("MD&A") of Peer 1 Network Enterprises, Inc. ("PEER 1" or "the Company"), dated September 21, 2009, should be read in conjunction with PEER 1's unaudited first, second and third quarter financial statements, as well as the audited annual financial statements for the fiscal year ended June 30, 2009 and the notes thereto, all of which can be found on [www.sedar.com](http://www.sedar.com). Unless otherwise noted, all figures noted are in United States dollars.*

**FORWARD LOOKING STATEMENTS**

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

The forward-looking statements set forth herein reflect the Company's expectations as at the date of this MD&A and are subject to change after that date. Unless otherwise required by applicable securities laws, the Company and its management expressly disclaim any intention, and assume no obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

**COMMENT ON CURRENT GLOBAL ECONOMIC CONDITIONS**

The Company's operating results have been impacted by the current recession, worldwide political and economic uncertainties and specific conditions in the markets we address.

Worldwide economic conditions have deteriorated materially in the last year. These conditions make it difficult for both the Company and its customers to accurately forecast and plan future business activities. Additionally, they could cause businesses to slow spending on the Company services, which could delay and lengthen the Company's new customer sales cycle and cause 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'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 Year Financial Highlights**

- PEER 1's revenue increased 3.32% to \$92.31 million for the year ended June 30, 2009, compared to \$89.35 million for the year ended June 30, 2008. 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 6.26%.
- Gross profit decreased 1.88% to \$39.75 million for the year ended June 30, 2009, compared to \$40.51 million for the year ended June 30, 2008.
- Operating income decreased 16.05% to \$12.33 million for the year ended June 30, 2009, compared to \$14.69 million for the year ended June 30, 2008.
- Income before income taxes was \$10.38 million for the year ended June 30, 2009 compared to \$12.3 million for the year ended June 30, 2008.
- Net income was \$5.72 million for the year ended June 30, 2009, compared to \$7.06 million for the year ended June 30, 2008.

### **Fiscal Year Developments**

- On June 25, 2009, PEER 1 announced that it had launched its CloudXcelerator™ program, which enables PEER 1 partners to develop, test and run their cloud applications on PEER 1's IT hosting infrastructure. Apprenda Inc., the creators of SaaSGrid, a powerful Cloud Application Server for rapidly building and commercializing Software as a Service (SaaS) applications, joins PEER 1 as its first CloudXcelerator partner.
- On June 25, 2009, PEER 1 announced that it had entered into a credit agreement with National Bank Financial Group for a term and a revolving credit facility of US\$40 million in aggregate. The new facilities replace the credit facilities that were provided by Fortress Credit Corp, but on terms that are less costly and more flexible.

- On May 12, 2009 PEER 1 announced that it entered into a long term lease on a site that will accommodate the construction of a 41,000 square foot green data center in the greater Toronto area. The new facility will implement some of the most efficient products and technologies on the market, including the use of a local well for primary water supply with redundant connection to the city water system to reduce overall carbon footprint and provide lower energy consumption. The first of four planned stages is scheduled for completion in early 2010. It will include 7,500 square feet of data center space and 8,000 square feet of office and staging area at an estimated capital cost of US\$10 million. The facility will have capacity for approximately 700 normal cabinet equivalents (NCE) for colocation, and 9,000 servers for managed and dedicated hosting, with the flexibility to alter the mix of these core services based on future customer demand. The remaining 25,500 square feet will be dedicated to additional datacenter space and infrastructure which will be built out in three future phases based upon customer demand and market conditions.

The new data center will offer scalable managed hosting, dedicated hosting through the ServerBeach brand and colocation services, the first time all three services will be offered by the company from a Canadian facility.

- On April 27, 2009, the Company announced that it had opened its European office and brought its new UK Data center online, naming industry veteran Dominic Monkhouse managing director of PEER 1 (UK) Ltd. The UK data center strengthens the company's presence in Europe alongside existing London and Amsterdam network Points-of-Presence (PoPs). The data center offers managed and dedicated hosting services to PEER 1 and ServerBeach customers through an initial provision of 100 secure racks.
- On October 21, 2008, the Company announced that it expanded its SAN-based backup offerings to colocation and ServerBeach dedicated hosting customers. Leveraging IBM's Tivoli Storage Manager software in each of its three service lines, PEER 1's colocation customers now have a hosted backup option, a feature that is not common in the colocation space. ServerBeach customers can also now take advantage of this enterprise-class backup offering, regardless of their business size, for a higher level of protection and to avoid critical downtime and revenue loss.
- On October 15, 2008, the Company announced that it had partnered with Absolute Performance to offer a suite of advanced monitoring solutions that will serve the growing needs of PEER 1's customers. The new advanced solutions available starting the third quarter of fiscal 2009 expand current offerings and provide a 360 degree view of system and application health. Monitoring also offers in-depth analysis to help both customers and PEER 1 better understand and meet IT needs in order to reduce risks and costs, as well as create more efficient, profitable systems.
- On October 2, 2008, the Company announced that it launched the PEER 1 Partner Network, an integrated Referral and Reseller Program targeted towards web developers, system integrators and IT consultants. These programs are designed to provide PEER 1 partners with an opportunity to strengthen their relationships with existing clients, offer revenue incentives to refer business and in turn increase revenue for both PEER 1 and its partners.
- On September 5, 2008, the Company entered into a lease amending agreement which allowed for an expansion at the existing leased data center facility in Herndon, Virginia. The agreement provides 8,614 square feet of additional contiguous space and increased the company's capacity by approximately 2880 servers.

## **THE BUSINESS**

PEER 1 is a premier Internet infrastructure provider, delivering managed, dedicated, colocation and network services through 16 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 has chosen to focus on small and medium-sized businesses worldwide. To effectively compete, this target market has become reliant on sophisticated Internet infrastructure that, in the past, has been typically deployed at larger enterprises. However, managing, monitoring, administering, and maintaining a sophisticated Internet infrastructure can rapidly deplete the limited resources of small and medium-sized businesses which need to be directed at core business activities. These complex and growing demands necessitate a closer relationship with a value-added, solutions oriented Internet infrastructure service provider such as PEER 1.

The Company views the North American market for Internet infrastructure as highly fragmented, with no single dominant player focused on the small and medium-sized business marketplace. Specifically, PEER 1 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 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 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 believes that

outsourcing these functions will allow organizations to focus capital and personnel resources on their core business operations, as opposed to Internet infrastructure.

## **SERVICES AND SOLUTIONS**

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

### **MANAGED HOSTING**

Managed hosting is an arrangement with a customer in which PEER 1 provides them with the use of server and related technology and a collection of services designed to ensure the proper management of that technology in the light of the customer's objectives. These services and technology include the following:

- PEER 1 provides data backup and recovery solutions designed to make backups and restorations faster and more flexible with minimal customer impact.
- PEER 1 provides firewall technology to protect servers against online exploitation. PEER 1 customizes firewall rule sets in accordance with customer objectives with a view to balancing the need for protection from illegitimate access against the need to allow unimpeded legitimate access.
- PEER 1 provides dedicated switches and devices that provide a private communication link between servers and assist its customers in managing their bandwidth consumption.
- PEER 1 provides vulnerability scanning services to satisfy customer demands for periodic server security audits.
- PEER 1 provides advance system monitoring services to enable its customers to address potential problems before they become actual problems.
- PEER 1 provides load balancing services that 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's different datacenters.
- PEER 1 provides a caching system that directs the customers' clients to the nearest caching server or node, allowing for faster delivery of web content than is possible without caching. This system is also made available as part of all of the Company's other services offerings.
- PEER 1 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 provides RapidReboot™ to enable customers to remotely restart their servers, eliminating the need for an on-site technician to manually re-start them.
- PEER 1 provides RapidRescue™ to enable servers running the Linux operating system to be rescued by the Company's customers from potentially fatal errors. Customers can recover and repair corrupted file systems, gain immediate access to the server, and boot the server into rescue mode without the help of an on-site technician.
- PEER 1 provides backup technology to enable customers to back-up their critical data on a separate device.
- PEER 1 provides control panel technology designed to simplify and automate, and thereby reduce the costs associated with the management and administration of web sites.
- PEER 1 provides a variety of options for port speed and bandwidth allotment that can be tailored to meet the requirements of each customer.
- PEER 1 provides 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's premises in order to access PEER 1's high quality Internet infrastructure, large bandwidth capacity, redundant power supply, security and technical support. This type of arrangement also enables customers to easily increase the Internet-related aspects of their business with minimal disruption. PEER 1's colocation services include the following:

- PEER 1 hosts customer domain names on a fully redundant distributed environment providing the customer with fast performance and reliable uptime over the Internet.
- PEER 1's port monitoring service enables its customers to define their minimum and maximum thresholds for bandwidth and packets per second usage, and alerts them by email once the threshold has been reached. This service also enables PEER 1 customers to better manage network costs and alerts customers of reductions in traffic to their sites due to server crash, hardware failure or web site configuration issues.

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

## **IP BACKBONE NETWORK SERVICES**

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

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

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

## **LEVERAGING AUTOMATION**

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

### **STRATEGIC ACQUISITIONS**

PEER 1 will seek to exploit the opportunities presented by 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 five years ended June 30, 2009.

## SELECTED ANNUAL INFORMATION

The following table sets forth selected financial information for Peer 1 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's audited financial statements for the three years ended June 30, 2009.

(in \$ thousands, except per share items)	Year Ended June 30,		
	2009	2008	2007
<b>Statement of Operations Data</b>			
Hosting Services	67,229	61,950	52,696
Bandwidth	8,345	9,950	8,478
Colocation	12,069	12,571	9,901
Services	4,666	4,876	3,023
<b>Total Revenue</b>	<b>92,309</b>	<b>89,347</b>	<b>74,097</b>
Total Cost of Sales	52,560	48,835	45,594
Gross Profit	39,749	40,512	28,504
Total Operating Expenses	27,419	25,824	21,153
Operating Income	12,330	14,688	7,350
Non-Operating expenses	1,946	2,386	6,398
Income Taxes	4,661	5,237	(2,678)
<b>Net Income</b>	<b>5,722</b>	<b>7,064</b>	<b>3,631</b>
Earnings per share (basic & diluted)	0.05	0.06	0.04
<b>Balance Sheet Data</b>			
Cash	15,744	11,026	9,259
<b>Current Assets</b>	<b>20,560</b>	<b>15,982</b>	<b>15,764</b>
<b>Total Assets</b>	<b>66,430</b>	<b>60,198</b>	<b>54,086</b>
Current portion of notes payable	2,250	3,286	3,350
Current portion of obligation under capital lease	211	226	-
<b>Current Liabilities</b>	<b>15,789</b>	<b>17,523</b>	<b>17,037</b>
Deferred gain	493	571	650
Deferred lease inducements	664	739	967
Notes Payable	12,303	12,008	16,257
Obligation under capital lease	363	655	-
<b>Total Liabilities</b>	<b>29,790</b>	<b>31,496</b>	<b>34,911</b>
<b>Shareholders' Equity</b>	<b>36,640</b>	<b>28,702</b>	<b>19,175</b>
<b>Total Liabilities &amp; Shareholders' Equity</b>	<b>66,430</b>	<b>60,198</b>	<b>54,086</b>

## 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 three year terms.

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

	Twelve Months ended June 30			
	2009	%	2008	%
Revenue:				
Colocation	12,069	13%	12,571	14%
Bandwidth	8,345	9%	9,950	11%
Services	4,666	5%	4,876	5%
Colocation Services	25,080	27%	27,396	31%
Hosting Services	67,229	73%	61,950	69%
<b>Total Revenue</b>	<b>\$ 92,309</b>	<b>100%</b>	<b>\$ 89,347</b>	<b>100%</b>

Revenue increased to \$92.31 million for the year ended June 30, 2009 from \$89.35 million for the year ended June 30, 2008. The increase in revenue is attributable to organic growth partly offset by the effect of the decline in value of the Canadian dollar against the US dollar. When adjusted for the exchange rates in effect in the prior year period, revenue for the twelve months ended June 30, 2009 was \$94.94 million. Taking into account the effect of the differing exchange rates between the Canadian and US dollars for the comparative period, revenue grew 6.26% for the twelve months ended June 30, 2009.

Colocation revenues decreased to \$12.07 million for the year ended June 30, 2009 from \$12.57 million for the year ended June 30, 2008. The decreases in revenue are attributable to the decreased value of the Canadian dollar against the US dollar offset in part by organic growth which will be constrained until the build out of phase one at the new Toronto area data center is completed. PEER 1's efforts to secure additional data centre space are ongoing. The effect on revenue of the decrease in value of the Canadian dollar against the US dollar was \$1.19 million for the twelve month periods ended June 30, 2009.

Bandwidth revenues decreased to \$8.35 million for the year ended June 30, 2009 compared to \$9.95 million for the year ended June 30, 2008. The decreases in revenue are primarily attributable to the decreased value of the Canadian dollar against the US dollar, pricing pressures as well as reduced overage charges as customers experienced lower bandwidth requirements due to the economic downturn. The effect on revenue of the decrease in value of the Canadian dollar against the US dollar was \$1 million for the twelve month periods ended June 30, 2009.

Hosting services revenues increased to \$67.23 million for the year ended June 30, 2009 from \$61.95 million for the year ended June 30, 2008. The increase for the year ended June 30, 2009 is attributable to organic growth. Hosting Services revenues have not been impacted by foreign exchange effects as currently, virtually all Hosting Services sales are denominated in United States Dollars.

PEER 1's Canadian operations accounted for \$17.6 million of revenues for the year ended June 30, 2009 compared to \$20.08 million of revenues for the year ended June 30, 2008. This change is primarily related to unfavorable foreign exchange effects of \$2.63 million for the twelve months ended June 30, 2009.

## 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 to \$52.56 million for the year ended June 30, 2009 from \$48.84 million for the year ended June 30, 2008. Cost of sales as a percentage of revenue increased to 56.94% for the year ended June 30, 2009 from 54.66% for the year ended June 30, 2008. The increase in cost of sales as a percentage of revenue is attributable to increased costs including staffing and facilities rent during the fiscal years ended June 30, 2009 compared to the same period last year. Revenue increased 3.32% for the year ended June 30, 2009, compared to the year ended June 30, 2008 while cost of sales increased 7.63% in the same period.

The increase in cost of sales for the 12 months ended June 30, 2009 compared to the same period in the prior year is primarily due to increased staff costs of \$0.75 million, increased depreciation costs of \$1.93 million, increased software license costs of \$0.54 million, increased power costs of \$0.53 million and increased rent costs of \$0.6 million associated with data center expansion in Toronto (started October 2008) and Herndon (started January 2009), offset in part by decreased costs of \$0.49 million for bandwidth and decreased repairs and maintenance costs of \$0.21 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 and bandwidth costs. During the year, the Company expanded its data centers in Toronto, Herndon and London. As a result, rent, amortization and staffing cost increased compared with the previous year. As these data centers are filled, cost of sales as a percentage of revenue will drop.

## 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.

	Twelve Months ended June 30			
	2009	%	2008	%
(In thousands \$)				
Total Operating Expenses	\$ 27,419	29.70%	\$ 25,824	28.90%

Total operating expenses increased to \$27.42 million for the year ended June 30, 2009 from \$25.82 million for the year ended June 30, 2008. Operating expenses as a percentage of revenue increased to 29.7% for the year ended June 30, 2009 from 28.9% for the year ended June 30, 2008.

The increase in operating expenses for the 12 months ended June 30, 2009 is attributable to \$0.8 million higher staff and training cost, \$0.83 million higher stock based compensation, \$0.79 million higher advertising and marketing expenses, \$0.16 million in increased bad debt expense, increased commission expenses of \$0.53 million, offset in part by lower bonuses of \$0.54 million, and \$0.6 million lower business tax charges, a result of a charge of \$0.62 million in the prior year relating to retroactive sales tax, use tax and other taxes, and reductions in expense for certain other items of \$0.31 million. The increase in bad debt expense reflects a higher 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. The Company has experienced some increase in the age of receivables and a resulting increase in bad debt expense, which reflects prevailing economic conditions. The Company will continue to monitor receivables and bad debts given the recent economic downturn. During the year, the Company incurred cost of \$0.65 million related to its UK expansion which are included in operating expenses.

General and administrative expenses accounted for 54.75% of total operating expenses for the year ended June 30, 2009 compared to 60.75% for the year ended June 30, 2008. Total general and administrative expenses was lower than the prior year due to lower bonuses and lower sales and use tax expenses partly offset by additional stock based compensation and staffing cost. During the year, the Company incurred general and administrative expense of \$0.49 million related to its UK expansion.

Sales and marketing expenses accounted for 38.32% of total operating expenses for the year ended June 30, 2009 compared to 31.53% for the year ended June 30, 2008. The increase in sales and marketing expenses as a percentage of operating expenses for the year ended June 30, 2009 is attributable to higher commission and marketing costs related to PEER 1's marketing initiatives to support growth.

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

#### **Other Income and Expenses:**

Interest income for the year ended June 30, 2009 was \$0.07 million compared to \$0.33 million for the year ended June 30, 2008.

#### **Interest Expense**

Interest expense decreased to \$2.19 million for the year ended June 30, 2009 compared to \$2.27 million for the year ended June 30, 2008 primarily due to lower interest rates on a lower balance of term debt outstanding during the year partly offset by \$0.35 million in additional and one time written off financing costs related to payout of the Fortress loan.

#### **Income Tax Expense**

As at June 30, 2009 the Company has recorded a future tax asset of \$1.3 million based upon a number of factors, including PEER 1's recent history of profitability and ability to utilize non-capital loss carry forwards, an analysis of the expected timing of reversals of temporary differences and budgeted and forecasted earnings, after adjusting for non-deductible expenditures. Although realization is not assured, the Company believes it is more likely than not that certain future tax assets will be realized and therefore a future tax asset has been recorded.

For the year ended June 30, 2009, PEER 1 recorded total income tax expense of \$4.66 million.

The Company's effective tax rate of 44.9% differs from the combined federal, provincial and state tax rates due to in part to the effect of non-deductible expenses related to stock based compensation.

### **Liquidity and Capital Resources**

The Company has commenced construction of the new Toronto data center. The first of four planned stages is scheduled for completion in early 2010. It will include 7,500 square feet of data center space, and 8,000 square feet of office and staging area at an estimated capital cost of US\$10 million.

PEER 1 has historically financed operations through cash generated from operations, sale of common and preferred shares and issuance of debt. As at June 30, 2009, the Company had cash and cash equivalents of \$15.74 million compared to \$11.03 million as at June 30, 2008. The current portion of the Company's notes payable as at June 30, 2009 was \$2.25 million.

The Company had working capital of \$4.77 million at June 30, 2009 compared to a working capital deficit of \$1.54 million as the end of June 30, 2008. The Company anticipates current liquidity and cash generated from operations to be sufficient to fund existing operations for the foreseeable future.

### **Operating Activities**

Cash flow from operating activities for the year ended June 30, 2009 and 2008 was \$21.94 million and \$22.82 million, respectively. The decrease in cash provided by operations for the year ended June 30, 2009 resulted primarily from decreased cash flow from net income for the period.

### **Investing Activities**

Cash used for investing activities for the year ended June 30, 2009 and 2008 was \$15.97 million and \$17.87 million, respectively. The decrease in use of cash for the year ended June 30, 2009 compared to the year ended June 30, 2008 is primarily a result of the acquisition of property and equipment including approximately \$4 million for the acquisition of equipment related to the upgrade of the network in FY2008 partly offset by more expenditures on leasehold improvement in FY 2009 as a result of data center expansion in Toronto and Herndon.

### **Financing Activities**

Net cash outflows from financing activities for the year ended June 30, 2009 was \$1.16 million compared to cash outflows from financing of \$2.63 million for the year ended June 30, 2008. The decrease in cash outflow from financing activities for the year ended June 30, 2009 compared to the year ended June 30, 2008 is primarily a result of the Company having been advanced US\$15 million under the Credit Facility B with National Bank of Canada, of which US\$13.2 million was used to repay the loan outstanding with Fortress, providing the Company with US\$1.8 million in cash. Credit facility B has a term of three years and is repayable in 10 quarterly payments of seven hundred fifty thousand dollars.

## Contractual Obligations

	Payments due by period				
	<u>Total</u>	<u>Less than 1 year</u>	<u>1 to 3 years</u>	<u>4 to 5 years</u>	<u>After 5 years</u>
Notes Payable <sup>1</sup>	15,000	2,250	12,750	-	-
Capital Lease Obligations	620	240	380		
Facility Leases	42,457	6,469	12,843	11,029	12,116
Service Agreements – Bandwidth	4,034	3,362	672	-	-
Other Commitment – Software license	1,370	950	420	-	-
<b>Total Contractual Obligations</b>	<b>63,481</b>	<b>13,271</b>	<b>27,065</b>	<b>11,029</b>	<b>12,116</b>

<sup>1</sup> On May 29, 2009, the Company entered into credit agreement (the “CA”) with National Bank of Canada (“National”) under which National agreed to provide the Company with two credit facilities (the “Facilities”). Facility A is a three year revolving facility for a term of three years, for up to US\$25,000,000 (or the Canadian dollar equivalent). Facility B is a three year revolving facility for a term of three years but up to US\$15,000,000 (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 Facility A. At the Company’s option, the Company can convert Loans from one type to another.

Both Facilities mature on May 29, 2012. The Company may request that the maturity date of either Facility be extended for a further 364 days by giving notice to National at least 365 days before the maturity date. National may then offer to extend on terms set out in its offer. If the Company declines the offer, the maturity date will not be extended. The Facilities may not be extended for more than two 364 day periods.

Interest is payable on each Loan at the rate for that type of Loan plus a margin of 1.75% to 3.5% 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 0.50% to 0.65% depending on the Company’s performance. There is also a standby fee on Letters of Credit issued of 2.75% to 3.50% depending on the Company’s performance. In addition, there is an annual fee payable in Canadian dollars of .25% calculated on the maximum available amount of each Facility at such time (including all outstanding Loans). When the Company entered into the CA, the Company paid National a structuring fee of US\$200,000.

Facility B will be permanently reduced by 10 quarterly reductions of US\$750,000, the first reduction to be made on December 31, 2009. 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 if the repayment is made from operating cash flow or from the proceeds of an issuance of shares. If payment is made from another source a penalty will be payable on the repayment of the Loans made under Facility B of 0.75% if payment is made in the first year, 0.50% if payment is made in the second year and 0.25% if payment is made in the third year.

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, National 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 National as security for the Facilities.

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

On June 25, 2009 Credit Facility B was fully advanced in the amount of US\$15 million. At the same time that the Company was advanced \$US15 million under Facility B, the company entered into a three year interest rate swap arrangement which locks in the interest rate at 5.36% over the three year term of this loan.

As of the date of this MD&A , the Company has not made any drawdown on Facility A.

## OFF-BALANCE SHEET ARRANGEMENTS

As at June 30, 2009, PEER 1 has provided one letter of credit totaling US\$0.25 million as security to a landlord for a facility lease. The security for the facility lease will be required for the term of the lease. The letter of credit is secured by way of a term deposit which is included as part of the financial statement caption, Other assets.

## TRANSACTIONS WITH RELATED PARTIES

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

At June 30 amounts due to and from related parties were as follows (in thousands \$):

	<u>FY2009</u>	<u>FY2008</u>
Accounts receivable from companies owned or subject to significant influence by directors and principal shareholders	\$-	\$4
Accounts payable to companies owned or subject to significant influence by directors and principal shareholders	\$-	\$21

During the year ended June 30, 2009 transactions with related parties were as follows (in thousands \$):

	<u>FY2009</u>	<u>FY2008</u>
Revenues earned from companies owned or subject to significant influence by directors and principal shareholders	\$100	\$99
Other expenses incurred from companies owned or subject to significant influence by directors and principal shareholders	\$104	\$162

These transactions are in the normal course of operations and are measured at their exchange amounts. Other expenses incurred include management and consulting fees of \$104 (in thousands of dollars).

## SUMMARY OF QUARTERLY RESULTS

The following table sets forth selected financial information for PEER 1 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's audited financial statements for the year ended June 30, 2009.

	Quarter Ended (in thousands \$)							
	30-Sep	31-Dec	31-Mar	30-Jun	30-Sep	31-Dec	31-Mar	30-Jun
	2007	2007	2008	2008	2008	2008	2009	2009
	(US\$)	(US\$)	(US\$)	(US\$)	(US\$)	(US\$)	(US\$)	(US\$)
Revenue	20,959	22,224	22,772	23,392	23,504	23,640	22,649	22,516
Operating Profit	2,825	3,910	4,108	3,844	3,501	3,705	2,609	2,515
Net Income	1,246	1,882	2,201	1,733	1,726	2,005	1,414	577
Basic earnings per share	0.01	0.02	0.02	0.01	0.01	0.01	0.01	0.00
Fully diluted earnings per share	0.01	0.02	0.02	0.01	0.01	0.01	0.01	0.00

### Fourth Quarter Results

	Three months ended June 30			
	2009	%	2008	%
Revenue:				
Colocation	3,069	14%	3,240	14%
Bandwidth	2,011	10%	2,489	11%
Services	1,217	4%	1,265	5%
Colocation Services	6,297	28%	6,994	30%
Hosting Services	16,219	72%	16,397	70%
<b>Total Revenue</b>	<b>\$ 22,516</b>	<b>100%</b>	<b>\$ 23,392</b>	<b>100%</b>

### Revenue

Revenue decreased to \$22.52 million for the three months ended June 30, 2009 from \$23.39 million for the three months ended June 30, 2008. The decrease is primarily attributable to the decline in value of the Canadian dollar against the US dollar and adverse global economic conditions.

The decrease in revenue for the three months ended June 30, 2009 compared to the three months ended June 30, 2008 as a result of the decline in value of Canadian dollar denominated sales totaled \$0.69 million. When adjusted for the exchange rates in effect in the prior year period, revenue for the three months ended June 30, 2009 was \$23.21 million. Taking into account the effect of the differing exchange rates between the Canadian and US dollars for the comparative period, revenue decreased by 0.80% for the three months ended June 30, 2009.

Colocation revenues decreased to \$3.07 million in the three months ended June 30, 2009 from \$3.24 million for the three months ended June 30, 2008. The decrease is primarily attributable to the decline in value of the Canadian dollar against the US dollar. The effect on revenue of the decrease in value of the Canadian dollar against the US dollar was \$.31 million for the three month periods ended June 30, 2009.

Bandwidth revenues decreased to \$2.01 million for the three months ended June 30, 2009 compared to \$2.49 million for the three months ended June 30, 2008. The decreases in revenue are primarily attributable to the decreased value of the Canadian dollar against the US dollar, pricing pressures as well as reduced overage charges as customers experienced lower bandwidth requirements due to the economic downturn. The effect on revenue of the decrease in value of the Canadian dollar against the US dollar was \$0.26 million for the three months ended June 30, 2009.

Hosting Services revenues decreased to \$16.22 million for the three months ended June 30, 2009 from \$16.4 million for the three months ended June 30, 2008 due to churn and customer right sizing.

### Cost of Sales

Consolidated cost of sales increased to \$13.25 million for the three months ended June 30, 2009 from \$12.32 million for the three months ended June 30, 2008. Cost of sales as a percentage of revenue increased to 58.86% in the quarter ended June 30, 2009 from 52.68% for the quarter ended June 30, 2008. The increase in cost of sales compared to the same period in the prior year is primarily due increased staff costs of \$0.34 million, increased depreciation costs of \$0.35 million, increased rent costs of \$0.26 million associated with data center expansion in Toronto (started October 2008) and Herndon (started January 2009), increased power costs of \$0.06 million and increased repairs and maintenance costs of \$0.18 million, offset in part by decreased cost of \$0.34 million for bandwidth. Revenue decreased 3.74 % for the three months ended June 30, 2009, compared to the three months ended June 30, 2008 while cost of sales increased 7.55% in the same period.

The increase in cost of sales as a percentage of revenue is attributable to increased rent cost, a result of data center expansions, and increased staffing cost compared to the prior year while revenue decreased in the same period mainly due to churn (a cancellation of services), and customer right sizing (a reduction of planned expenditures).

### 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 Month ended June 30			
	2009	%	2008	%
(In thousands \$)				
Total Operating Expenses	\$ 6,748	29.97%	\$ 7,225	30.89%

Total operating expenses decreased to \$6.75 million for the three months ended June 30, 2009 from \$7.23 million for the three months ended June 30, 2008. Operating expenses as a percentage of revenue was 29.97% for the three months ended June 30, 2009 and 30.89% for the three months ended June 30, 2008.

The decrease in total operating expenses for the three months ended June 30, 2009 is primarily due to reduced bonuses of \$0.39 million, and \$0.62 million lower business tax expense, a result of a charge during the three months ended June 30, 2008 relating to retroactive sales tax, use tax and other taxes, partly offset by increased stock based compensation of \$0.18 million and increased commissions of

\$0.33 million. During the three months ended June 30, 2009, the company incurred \$0.43 million related to its UK expansion which are included in operating expenses.

General and administrative expenses accounted for 53.09% of total operating expenses for the three months ended June 30, 2009 compared to 63.66% for the three months ended June 30, 2008. The decrease in general and administrative expenses as a percentage of operating expenses for the three months ended June 30, 2009 is in part attributable to higher sales & marketing expenses as a proportion to overall operating expenses incurred during the current quarter compared to the same period last year. During the three months ended June 30, 2009, the company incurred general and administrative expenses of \$0.27 million related to its UK expansion.

Sales and marketing expenses accounted for 39.16% of total operating expenses for the three months ended June 30, 2009 compared to 30.24% for the three months ended June 30, 2008. The increase in sales and marketing expenses as a percentage of operating expenses for the three months ended June 30, 2009 compared to the same period last year is attributable to higher marketing and commission costs related to PEER 1's marketing initiatives to support organic growth and leveraged growth.

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

### **Interest Expense**

Interest expense increased to \$0.93 million for the three months ended June 30, 2009 compared to \$0.57 million for the three months ended June 30, 2008 primarily due to \$0.35 million in additional and one time written off financing costs related to payout of the Fortress loan partly offset by lower interest rates on term debt outstanding during the quarter.

### **Income Tax Expense**

For the three months ended June 30, 2009, PEER 1 recorded total income tax expense of \$1.05 million.

### **Liquidity and Capital Resources**

Cash and cash equivalents for the three months ended June 30, 2009 increased \$ 3.80 million over the same period in the prior year and was primarily the result of cash flow from financing activities of \$1.2 million compared to cash used from financing activities of \$0.8 million for the same period in the prior year. Cash outflow from investing activities was \$3 million compared to \$4.2 million in the prior year as a result of decreased cash outflow from capital expenditures during the quarter in the prior year. This is reduced in part from cash flow from reduced net income for the current quarter compared to the prior year.

## **SUBSEQUENT EVENTS AND PROPOSED TRANSACTIONS**

On August 31, 2009, PEER 1 announced changes to the board of directors in connection with Clairvest completing the purchase of 20,538,470 shares of PEER 1 from Celerity Partners on August 28, 2009. Mark Benham of Celerity Partners has resigned from the board of directors. Ken Rotman and Mitch Green have been appointed to the board as representatives of Clairvest. The appointment of Messrs. Rotman and Green is pursuant to an agreement between Clairvest and PEER 1's other major shareholders.

On July 30, 2009, PEER 1 announced that it had completed Type I examination in conformity with the American Institute of Certified Public Accountants (AICPA) Statement on Auditing Standards No. 70 (SAS 70) for Service Organizations.

Completion of the SAS 70 Type I audit indicates the successful examination of PEER 1's processes, controls at the Miami and Atlanta data centers, by the independent accounting and auditing firm Deloitte & Touche LLP. The formal examination entailed obtaining reasonable assurance that PEER 1's properly described, documented and implemented controls were relevant to the user organization's internal controls as they relate to their audited financial statements, and that such controls had been put in place as of May 30, 2009.

The Company has future plans to obtain a Type II report and has plans to expand the scope of the examination to cover other locations and service offerings.

## **OUTSTANDING SHARE DATA**

PEER 1 has authorized share capital of unlimited common shares without par value and unlimited preferred shares without par value. At June 30, 2009 119,314,323 common shares were issued and outstanding. As of the date of this MD&A 121,051,504 common shares were issued and outstanding.

At June 30, 2009 2,461,619 warrants for the purchase of shares ranging in price from US\$0.23 to CAD\$0.40 (approximately US\$0.34) were outstanding. Subsequent to the year ended June 30, 2009 and as of the date of this MD&A, 1,628,286 warrants were converted to common shares. As at the date of this MD&A, 833,333 warrants were outstanding. Subsequent to the year ended June 30, 2009 and as of the date of this MD&A, 112,500 options were exercised, 48,888 options expired, 26,112 options were forfeited and Nil additional options have been granted. Stock options outstanding as of the date of this MD&A are 15,840,350.

If all warrants and options were exercised there would be a total of 137,725,187 shares outstanding as of the date of this MD&A.

## **CRITICAL ACCOUNTING ESTIMATES**

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

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

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 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, 2009 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, 2009.

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.

## **CHANGES IN ACCOUNTING POLICIES**

In December 2006, the CICA released new Handbook Section 1535, this standard requires that an entity disclose information that enables users of its financial statements to evaluate an entity's objectives, policies and processes for managing capital, including disclosures of any externally imposed capital requirements and the consequences of non-compliance. As a result of adopting this standard, new or enhanced disclosure is provided in Note 16 – Capital risk management.

In January 2009, the CICA issued EIC Abstract 173, "Credit Risk and the Fair Value of Financial Assets and Financial Liabilities". The EIC requires the Company to take into account the Company's own credit risk and the credit risk of the counterparty in determining the fair value of financial assets

and financial liabilities, including derivative instruments. EIC 173 is to be applied retrospectively without restatement of prior periods to all financial assets and liabilities measured at fair value in the interim and annual financial statements for periods ending on or after the date of issuance of the Abstract. The Company has evaluated the impact of adopting this standard on its consolidated financial statements and no changes were made.

## **RECENT ACCOUNTING PRONOUNCEMENTS**

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

### Convergence with International Financial Reporting Standards (IFRS)

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 commenced 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. 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.

Initial training of key personnel started during the current reporting period and personnel have been identified to lead the transition effort. The Company has also engaged 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.

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.

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.

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, 2009 the Company has no non-controlling interests, and accordingly there is no currently expected impact as a result of the standard.

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 an 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.

## **ACCOUNTING POLICIES**

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

### **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 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, 2009.

### Derivative Financial Instruments

The Company uses derivative financial instruments in the management of its interest rate exposure. 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 HFT. The Company may choose to designate derivative financial instruments as hedging instruments for which hedge accounting is applied (see below).

Cash flow hedges – The Company has designated its interest-rate swap agreement as a cash flow hedge. As at June 30, 2009, the value of this swap decreased by \$0.268 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 believes, a larger base of customers. In addition, competitors may operate more successfully than PEER 1 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 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 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 Operating History**

The Company has a limited operating history upon which to evaluate its business and prospects, having commenced operations in 1999. Fiscal 2009 is only the Company's third year of profitable operations. There can be no assurance that the Company will continue to be profitable. In view of the rapidly evolving nature of our business, the Company's limited operating history and the risks discussed elsewhere in these risk factors, period-to-period comparisons of operating results are not meaningful and should not be relied upon as an indication of future performance.

### **Dependence on Personnel**

The Company's continued success is largely dependent on the personal efforts and abilities of its executive officers and 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**

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

### **Risk of Damage to 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 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. There can be no assurance that the result of the litigation described under "Legal Proceedings" will not be materially adverse to the Company.

## **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, 2009, revenue generated from the Company's largest leased data center represented 25% of the Company's consolidated revenues.

## **Reliance on Third Parties**

The Company purchase bandwidth from, or enter into interconnection arrangements with, several Internet service providers. The Company cannot provide any assurance that these Internet service providers will continue to provide service to 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 actual or anticipated fluctuations in the Company's results of operations or analysts' estimates, introduction of new products and global economic changes.

## **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, 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 of 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, 2009, 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 the Company's

common shares, representing approximately 64.9% 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. 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).