

# **PEER 1 NETWORK ENTERPRISES INC. MANAGEMENT DISCUSSION & ANALYSIS FOR THE SIX MONTHS ENDED DECEMBER 31, 2004**

*This Management Discussion and Analysis ("MD&A"), dated February 11 2005, should be read in conjunction with Peer1's unaudited second quarter statements, as well as the audited annual financial statements for the fiscal year ended June 30, 2004 and the notes thereto. All figures noted are in Canadian dollars.*

## **FORWARD LOOKING STATEMENTS**

This discussion includes certain forward looking statements in respect to various issues including upcoming events. These forward looking statements are based upon current expectations which involve risks and uncertainties that could cause actual outcomes and results to differ materially. Factors that could cause or contribute to such differences include, but are not limited to, general economic conditions, changes in technology, general sales risks, and limited intellectual property protection. Other risks and uncertainties are described in a subsequent section of this filing. The company disclaims any obligation to revise any forward looking statements as a result of information received after the fact or regarding future events.

## **PEER 1 NETWORK ENTERPRISES OVERVIEW**

### **Quarterly Highlights**

- Completed the acquisition of the assets of ServerBeach Ltd., a dedicated server provider.
- 51% increase in quarterly revenues (three months ended December 31, 2004 vs three months ended September 30, 2004) from \$3.8 million to \$5.7 million.
- Year to date revenues are 45% higher than for the same six month period in FY2004.
- Gross profit margins increase from 37% to 38%.
- \$260,000 improvement in the bottom line from a loss of \$750,000 in the first quarter of FY2005 to a loss of \$490,000 in the current quarter.
- Over \$1 million increase in EBITDA, from \$320,000 in the first quarter to \$1,330,000 in the current quarter.

### **Core Business**

Peer 1 Network Enterprises Inc. provides high performance internet bandwidth and co-location facilities to web-centric customers across North America. Building on a redundant, 100% Cisco powered internal network, Peer 1 guarantees 100% uptime internet access for companies with mission-critical applications. The company has established local offices and co-location facilities in Vancouver, Toronto, Montreal, New York, Seattle, and San Jose and also has points of presence (POPs) in the USA in Chicago, Ashburn VA and Los Angeles, and in the UK in London.

## **Bandwidth**

Peer 1's bandwidth service is provided by way of an expansive, redundant network which is connected to multiple Tier 1 Internet providers in Canada and the US and which utilizes multiple major upstream providers and hundreds of peering partners to ensure continuous internet connectivity, greater route diversity, and ultimately, enhanced internet performance. Traffic generated from and received by our customers is charged for on a per unit basis, except for those who have committed to minimum usage levels.

## **Colocation**

The co-location service provided by Peer 1 involves the physical locating of a customer's switching gear or servers in one of the dedicated facilities operated by Peer 1, which is designed to provide the infrastructure necessary for the functioning of that equipment. Included in the required infrastructure would be such resources as a secured cage or cabinet, regulated power, emergency backup power, dedicated Internet connection, regulated air temperature and security.

The major benefits of co-location with Peer 1 are:

- Significantly reduced costs of staff, facilities and hardware
- Reduced configuration and management issues
- Access to a very high bandwidth, high quality IP network
- 24 hours, 7 days a week monitoring
- An environmentally protected facility
- High level of physical security
- Lower costs compared to "in house" solutions

Colocation customers are charged for the service provided by way of a monthly rental charge.

## **Dedicated Servers**

ServerBeach was launched in response to a real need exhibited in the marketplace for unmanaged dedicated servers. The company offers discount dedicated servers to the technology hobbyist. Built on solid hardware, a reliable network and burstable bandwidth, ServerBeach provides Linux and Microsoft users with a low-cost dedicated server, complete with a full set of developer's tools.

## **STRATEGY**

Peer 1 Network Enterprises, Inc. management is implementing a three-level growth strategy initiative. The three elements of the strategy initiative are organic growth, leveraged growth, and accelerated growth. The organic growth strategy is predicated on the fact that the current business will continue to add more customers and expand the network's reach into key peering points worldwide. The company's leveraged growth strategy builds on the introduction of new products and services that leverage the infrastructure that Peer 1 has already has in place and is paid for. Peer 1's accelerated growth strategy focuses on actively pursuing acquisitions that are accretive to the Peer 1 business based on well defined criteria for a target company's performance and growth potential.

## **Network**

Peer 1 has built a “clear channel” backbone network connecting all of Peer 1’s facilities using multiple high-speed OCn connections. Hundreds of peering relationships and traffic exchange agreements have been established with other networks. The peering arrangements are fundamental to the company’s strategy. Peering is a relationship between two or more networks of any size in which the networks create a direct link between each other and agree to forward each other’s packets directly across this link instead of using the standard Internet backbone. This has two main advantages: first, it reduces latency between the two networks; and secondly, it avoids additional costs associated with a third party network.

## **Colocation Facilities**

Peer 1’s strategy is to establish a point of presence in a new market by colocation in facilities owned by other suppliers, in order to gauge market demand, prior to making a decision to open up our own colocation facility. When a market is deemed to be viable, the company identifies suitable space for long term lease. Wherever possible, sites that have previously been operated as data centres are sought, since this reduces the initial capital investment required. All equipment is acquired and installed on a phased basis, again to reduce the capital investment required. As market share grows, additional equipment is acquired.

## SECOND QUARTER INFORMATION

### Segmented Information

As this is the first quarter for which the reported results include the operations of ServerBeach, the following additional financial information is provided to facilitate comparisons to previous periods.

Peer 1 Network Enterprises, Inc. Segmented Balance Sheet As At December 31, 2004 (unaudited - prepared by management)				
	12/31/2004 Peer 1	12/31/2004 ServerBeach	12/31/2004 Total	12/31/2003 Peer 1
<b>Assets</b>				
<b>Current:</b>				
Cash and cash equivalents	704,601	955,121	1,659,722	976,848
Accounts receivable	2,303,029	-	2,303,029	2,139,565
Inventory	0	54,110	54,110	-
Prepaid expenses	334,877	550,929	885,806	305,724
	<u>3,342,507</u>	<u>1,560,160</u>	<u>4,902,667</u>	<u>3,422,137</u>
<b>Other assets</b>	1,573,431	-	1,573,431	794,804
<b>Property, plant and equipment</b>	6,333,350	2,996,110	9,329,460	5,300,519
<b>Goodwill, licences and other intangibles</b>	0	6,286,652	6,286,652	-
	<u>11,249,288</u>	<u>10,842,922</u>	<u>22,092,210</u>	<u>9,517,460</u>
<b>Liabilities</b>				
<b>Current Liabilities</b>				
Accounts payable and accrued liabilities	3,292,202	1,372,282	4,664,484	2,201,583
Deferred revenue	635,567	428,923	1,064,490	571,156
Current portion of deferred lease inducements	11,800	-	11,800	11,800
Current portion of notes payable	510,289	-	510,289	510,289
Shareholder notes	2,509,304	-	2,509,304	1,315,341
	<u>6,959,162</u>	<u>1,801,205</u>	<u>8,760,367</u>	<u>4,610,169</u>
<b>Deferred lease inducements</b>	144,531	0	144,531	150,431
<b>Notes payable</b>	3,323,332	8,915,250	12,238,582	3,319,312
	<u>10,427,025</u>	<u>10,716,455</u>	<u>21,143,480</u>	<u>8,079,912</u>
<b>Shareholders' Equity (Deficiency)</b>				
<b>Capital Stock</b>	9,915,992	-	9,915,992	9,914,432
<b>Warrants</b>	-	-	-	-
<b>Contributed Surplus</b>	220,355	-	220,355	435,638
<b>Equity component of convertible debt</b>	435,638	-	435,638	220,355
<b>Retained Earnings (Deficit)</b>	(9,749,722)	126,467	(9,623,255)	(9,132,877)
	<u>822,263</u>	<u>126,467</u>	<u>948,730</u>	<u>1,437,548</u>
	<u>11,249,288</u>	<u>10,842,922</u>	<u>22,092,210</u>	<u>9,517,460</u>

**Peer 1 Network Enterprises, Inc.**  
**Segmented Income Statement**  
**Three Months Ended December 31**  
**(unaudited - prepared by management)**

	Three Months Ended December 31, 2004 Peer 1	Three Months Ended December 31, 2004 ServerBeach (since Oct 20/04)	Three Months Ended December 31, 2004 Total	Three Months Ended December 31, 2003 Peer 1
Revenue	4,157,641	1,535,760	5,693,401	3,407,164
Cost of Sales	2,563,899	971,611	3,535,510	2,036,898
Gross Profit	1,593,742	564,149	2,157,891	1,370,266
Operating expenses	1,662,873	632,378	2,295,251	1,303,681
Operating profit (loss)	(69,131)	(68,229)	(137,360)	66,585
Interest expense	174,509	266,395	440,904	144,519
Interest accretion on convertible debt	92,620	-	92,620	193,014
Foreign exchange loss (gain)	(31,442)	(466,128)	(497,570)	(22,310)
Income (loss) before income taxes	(304,818)	131,504	(173,314)	(248,638)
Provision for income taxes	358	5,037	5,395	-
Income (loss) for the period	(305,176)	126,467	(178,709)	(248,638)
Deficit, beginning of period	(9,444,546)	-	(9,444,546)	(8,645,294)
Deficit, end of period	(9,749,722)	126,467	(9,623,255)	(8,893,932)
<b>EBITDA</b>	272,241	847,621	1,119,862	277,177

**Peer 1 Network Enterprises, Inc.**  
**Segmented Income Statement**  
**Year To Date**  
**(unaudited - prepared by management)**

	Six Months Ended December 31, 2004 Peer 1	Six Months Ended December 31, 2004 ServerBeach (since Oct 20/04)	Six Months Ended December 31, 2004 Total	Six Months Ended December 31, 2003 Peer 1
Revenue	7,937,772	1,535,760	9,473,532	6,520,374
Cost of Sales	4,919,516	971,611	5,891,127	4,087,339
Gross Profit	3,018,256	564,149	3,582,405	2,433,035
Operating expenses	3,145,353	632,378	3,777,731	2,562,913
Operating profit (loss)	(127,097)	(68,229)	(195,326)	(129,878)
Interest expense	335,266	266,395	601,661	290,460
Interest accretion on convertible debt	185,238	-	185,238	386,029
Foreign exchange loss (gain)	(38,470)	(466,128)	(504,598)	(52,962)
Income (loss) before income taxes	(609,131)	131,504	(477,627)	(753,405)
Provision for income taxes	7,714	5,037	12,751	-
Income (loss) for the period	(616,845)	126,467	(490,378)	(753,405)
Deficit, beginning of period	(9,132,877)	-	(9,132,877)	(8,140,527)
Deficit, end of period	(9,749,722)	126,467	(9,623,255)	(8,893,932)
<b>EBITDA</b>	485,526	847,621	1,333,147	321,255

Peer 1 Network Enterprises, Inc.				
EBITDA Reconciliation				
Three Months Ended December 31				
(unaudited - prepared by management)				
	Three Months Ended December 31, 2004	Three Months Ended December 31, 2004	Three Months Ended December 31, 2004	Three Months Ended December 31, 2003
	Peer 1	ServerBeach (since Oct 20/04)	Total	Peer 1
Net Profit (Loss)	(305,176)	126,467	(178,709)	(248,638)
Interest Expense	159,109	107,414	266,523	144,519
Accreted Interest	92,620	-	92,620	193,014
Amortization - fixed assets	309,930	248,564	558,494	188,282
Amortization - startup costs	-	-	-	-
Amortization - loan origination fees	15,400	158,981	174,381	-
Amortization - acquisition costs	-	12,207	12,207	-
Amortization - licence fees	-	188,951	188,951	-
Taxes	358	5,037	5,395	-
	<u>272,241</u>	<u>847,621</u>	<u>1,119,862</u>	<u>277,177</u>

EBITDA Reconciliation				
Year To Date				
(unaudited - prepared by management)				
	Six Months Ended December 31, 2004	Six Months Ended December 31, 2004	Six Months Ended December 31, 2004	Six Months Ended December 31, 2003
	Peer 1	ServerBeach (since Oct 20/04)	Total	Peer 1
Net Profit (Loss)	(616,845)	126,467	(490,378)	(753,405)
Interest Expense	304,444	107,414	411,858	290,460
Accreted Interest	185,238	-	185,238	386,029
Amortization - fixed assets	564,469	248,564	813,033	398,171
Amortization - startup costs	9,684	-	9,684	-
Amortization - loan origination fees	30,822	158,981	189,803	-
Amortization - acquisition costs	-	12,207	12,207	-
Amortization - licence fees	-	188,951	188,951	-
Taxes	7,714	5,037	12,751	-
	<u>485,526</u>	<u>847,621</u>	<u>1,333,147</u>	<u>321,255</u>

## Overall Performance

Selected Measures of Financial Position	December 2004	June 2004	June 2003
Cash (including restricted cash)	\$1,659,722	\$976,848	\$650,907
Total Assets	\$22,092,210	\$9,517,460	\$6,494,277
Working Capital	\$-3,857,700	\$-1,188,031	\$-1,562,265
Long Term Financial Liabilities	\$12,238,582	\$3,319,312	\$3,235,074
Share Capital	\$9,915,992	\$9,914,432	\$6,779,922
Shareholders' Equity	\$948,730	\$1,437,548	\$-511,783

On October 20, 2004, the company, through its 100% owned subsidiary, P1 Acquisition, Ltd. ("P1") acquired all of the operating assets of San Antonio, Texas-based ServerBeach, Ltd. Included in the operating assets were existing customer contracts, an exclusive use licence for technology that is essential to the ServerBeach business and over 4,200 dedicated servers. The staff and management of ServerBeach were offered employment at P1 to operate the business with 85% accepting employment. As part of the purchase of assets, the company obtained rights to the company name and was granted the authority to rename P1 Acquisition, Ltd. to ServerBeach, Ltd. on October 22

and now operates under that name. The transaction was approved by the TSX Venture Exchange prior to the closing. The financial impact of this transaction is evident in the increase in total assets.

The increase in long term financial liabilities is a result of the financing of the ServerBeach purchase price, which was US\$7.5 million. Peer 1 arranged bridge financing for the full purchase price from a company related to one of its Directors on commercially reasonable terms and due on June 30, 2005 with certain renewal provisions thereafter. The loan carries an interest rate of 6% per annum through December 31, 2004 and thereafter at 15% per annum. The company plans to refinance the bridge financing in the first half of calendar 2005.

In accordance with regulatory requirements, the company filed a Business Acquisition Report which provides additional detail about ServerBeach's historical results, as well as pro-forma financial statements.

Shareholder contributions of over \$1 million in demand notes were made this quarter to finance the ongoing investment in assets. Additional investment in power and air conditioning equipment in the Vancouver, Toronto and New York colocation facilities has been necessitated by the growth in customers in these locations. Peer 1 has also committed to additional facility space in Toronto, New York and Herndon, Virginia – further investment of approximately \$2.2 million will be required during the next two quarters in order to outfit these new facilities.

<b>Selected Measures of Operations</b>	<b>YTD Q2 2005</b>	<b>YTD Q2 2004</b>	<b>YTD Q2 2003</b>
Total Revenue	\$9,473,532	\$6,520,374	\$4,447,313
Gross Margin	37.8%	37.3%	16.7%
Net Loss	\$490,378	\$753,405	\$1,842,727

Revenues as of the end of the second quarter were 45% higher than for the same period last year, which in turn was 47% higher than that for the preceding year. Slightly more than half of the growth is directly attributable to the acquisition of ServerBeach.

The increase in revenue has not been matched by the increase in gross margin. This is due to capacity addition during the last year (which affects colocation gross margins), as well as lower margins on bandwidth revenues.

## **RESULTS OF OPERATIONS**

The company now has three distinct but related business segments – the provision of colocation and bandwidth services, the rental of dedicated servers and the provision of voice over IP (VOIP) services. The colocation and bandwidth segment is the area of business that Peer 1 has historically provided services in. The ServerBeach acquisition has facilitated entry into the dedicated server segment, while VOIP services are provided through the company's joint venture entity, Symmetric Broadband. Prior to the second quarter of this year, Symmetric Broadband was in the startup phase, with all costs deferred (deferred startup costs amounted to \$235,000). Symmetric is now considered to be an operating entity, whose revenues and costs are included in operations. The startup costs are being amortized over a three year period.

## **Revenues**

73% of the revenue this quarter was generated from colocation and bandwidth sales, with revenues from dedicated servers accounting for the vast majority of the balance. VOIP revenues accounted for less than half of one percent this quarter.

### Colocation and Bandwidth

Colocation revenues increased from \$1.0 million in the second quarter of FY2004 to \$1.6 million in the second quarter of FY2005 (58% growth). The increase from the previous quarter in FY2005 was \$0.1 million (6%). The increase is directly attributable to growth in the customer base - the number of colocation customers grew from 509 at the end of the second quarter of FY2004 to 734 by the end of the current quarter, which translated into a 44% increase in the number of units sold each month (the increase from the end of the previous quarter was 7%). The average selling price per customer and per unit has increased slightly from FY2004.

This quarter, for the first time in almost a year, bandwidth revenues showed quarter over quarter growth (6%). Although the trend of falling bandwidth prices resulting from a highly competitive market continued this quarter, traffic was 37% higher this quarter than last, thereby offsetting the downward pressure on revenues. The ratio of colocation to bandwidth revenues is now 43%:57% (same as last quarter), compared to 32%:68% at the end of the second quarter of FY2004.

Year to date, 83% of revenues earned were from the company's three Canadian sites, compared to 90% at the end of the second quarter of FY2004 and 83% in the immediately preceding quarter. Sales at the US locations continue to grow, with Seattle and New York recording the majority of the increase. A new sales team has been added in California, to promote growth in that market. Management expects that the US locations will continue their sales growth, as Peer 1 brand recognition increases.

The company continues to monitor capacity utilization closely, in order to ensure that anticipated growth is not adversely affected by a lack of available space. Space has been added in Toronto and New York, the two locations where capacity utilization has been higher than the company target.

### Dedicated Servers

This quarter's results only include revenue from ServerBeach from the date of acquisition (just over two months' billings, less one month's deferred revenue), and so is not indicative of the extent that ServerBeach is expected to contribute to overall revenues. Management anticipates that monthly revenue from the rental of dedicated servers will be in the US\$650,000 range..

### VOIP

Revenues from VOIP sales are not expected to be significant in relation to the overall operating results for the rest of the fiscal year. The company is still in its infancy, and needs to establish its reputation in the market before more significant revenue growth is expected.

## **Gross Profit**

Gross profit margins have increased only slightly from last fiscal year to this, primarily because bandwidth margins have been negatively impacted by falling bandwidth prices. In past quarters, Peer 1's cost of acquiring high quality bandwidth was also falling rapidly, however the rate of decline has now slowed. However, the lower prices have resulted in volume growth, with the result that in dollar terms, gross profit at the end of the second quarter in FY2005 is 26% higher than it was at the end of the same quarter in FY2004.

ServerBeach gross margins are expected to be in the same range as those for the colocation and bandwidth segment of Peer 1's business, with the exception of the third quarter when additional costs will be incurred to relocate the ServerBeach equipment from a facility provided by the previous owner to a new Peer 1 facility in Virginia. Once the move is completed, gross margins are expected to climb back to normal levels.

## **Operating Expenses**

### Colocation and Bandwidth

The largest component of operating expenses is salaries and wages which, year to date, comprise approximately 56% of the total (52% for the same period in FY2004). The higher proportion is attributable to an increase in the number of sales people on staff (sales staff were added to the new US locations) as well as higher sales commissions that are a result of the increase in revenues. It is expected that this component will continue to increase relative to other operating expenses as sales continue to increase.

Rent and administration costs make up the next most significant component at 22% of total operating costs down from 26% in FY2004. Management continues to focus on administration costs to ensure that operations are as efficient as possible. No major changes are anticipated for the costs in this category.

Travel costs are 13% of total operating expenses, unchanged from FY2004. With the addition of a POP in London, and the investigation of market opportunities in Europe, this component is expected to be of greater significance in the coming year.

Professional fees account for 9% of total costs this quarter, unchanged from FY2004. No major changes are anticipated for the costs in this category.

## SUMMARY OF QUARTERLY RESULTS

	Quarter Ended							
	March 31 2003	June 30 2003	September 30 2003	December 31 2003	March 31 2004	June 30 2004	September 30 2004	December 31 2004
Revenue	2,463,147	3,023,564	3,113,210	3,407,164	3,400,250	3,667,290	3,780,131	5,693,401
Operating Profit (Loss)	(781,605)	(452,534)	(196,463)	66,585	156,654	(64,459)	(57,966)	(296,341)
Net Income (Loss)	(773,907)	(664,701)	(504,767)	(248,638)	5,969	(244,914)	(311,669)	(178,709)
Pro forma basic and fully diluted income (loss) per share	(0.02)	(0.02)	(0.01)	(0.01)	0.00	(0.01)	(0.01)	(0.00)
EBITDA	(556,320)	(206,386)	44,078	277,177	421,865	124,530	213,285	1,119,862

### LIQUIDITY AND CAPITAL RESOURCES

As of December 31, 2004 the company had a cash and cash equivalents balance of \$1.6 million.

The company had a working capital deficit at the end of each of the last two quarters (\$3.8 million after the second quarter of FY2005 and \$2.3 million at the end of the preceding quarter). Included in this amount are the short term shareholder notes and the accrued interest thereon. If these items are excluded from the calculation, on the assumption that shareholders would be unlikely to impact liquidity in a negative manner, the working capital deficit is reduced to \$1.3 million at the end of the most recent quarter and a \$0.9 million deficit at the end of the preceding quarter.

#### Operating Activities

Operating activities, prior to consideration of the change in working capital balances, in the second quarter of FY2005 generated three times more cash than in the same quarter last year. This is primarily because the increase in revenues was greater than the commensurate increase in cash based expenses. Future revenue growth is also expected to follow this trend, with the result that cash flows are anticipated to continue from operations in the coming year.

#### Investing Activities

Investing activities during the quarter reflect the acquisition of the assets of ServerBeach, as well as ongoing capital investment. Continued investment of \$2.2 million in equipment and facilities for the colocation and bandwidth segment of the business, and \$0.6 million for equipment for the dedicated server segment will be required to the end of the fiscal year.

#### Financing Activities

The company financed its activities during the current quarter by way of a US\$7.5 million note, and shareholder debt of \$1.1 million. Additional financing by way of share issuance or debt will be required in the next quarter in order to sustain the continued growth plan. There are no assurances that the company will be able to obtain financing.

## OFF-BALANCE SHEET ARRANGEMENTS

The company has provided a letter of credit in the amount of US\$250,000 as security for a facility lease. The letter of credit is secured by way of a term deposit which is included in the reported cash balance. The year end financial statements will classify the term deposit as restricted cash.

## TRANSACTIONS WITH RELATED PARTIES

During the year Peer 1 provided services in the normal course of business to companies either owned or subject to significant influence by the company's directors and principal shareholders.

At the end of the second quarter amounts, due to and from related parties were as follows:

	<b>FY2005</b>	<b>FY2004</b>
Included in accounts receivable	\$134,121	\$155,557
Included in accounts payable and accrued liabilities	\$2,996	-

During the period, transactions with related parties were as follows:

	<b>FY2005</b>	<b>FY2004</b>
Revenues earned	\$91,090	\$296,282
Interest expensed	\$299,176	\$187,650
Other expenses incurred	\$93,232	-

These transactions are in the normal course of operations and are at measured at their exchange amounts. Included in other expenses incurred is \$70,000 in accounts receivable from a related party that was written off. This amounted to half of the balance receivable from that party.

## SUBSEQUENT EVENTS AND PROPOSED TRANSACTIONS

At the date of this MD&A, there were no proposed transactions related to the acquisition or disposition of assets or businesses that have been considered by the Board of Directors.

## 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 (see section below), 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 customer as well as overall historical collection trends. Our allowance is in the range of 2-2.5% of annual revenues.

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

The likelihood of M&A projects being completed are based on the facts involved in each particular case.

Valuation of the debt conversion features and issue of warrants is based on estimates of dividend yield (Nil), expected volatility of the Peer 1 stock price (75%), risk-free interest rate (estimate changes over time as actual results change) and option term (varies depending on the warrants or options issued).

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

## **ACCOUNTING POLICIES**

The company prepares its financial statements on the basis of accounting principals generally acceptable in Canada. All accounting policies have been applied on a basis consistent with that of the previous year.

During the year, as part of its growth strategy, the company undertook a process of identifying and pursuing organizations for potential acquisition. As a result, costs directly related to acquisitions were incurred. The company has adopted a policy of deferring such costs for proposed transactions where completion is considered to be more likely than not. These deferred costs will be added to the cost of purchase upon completion. Should the status of a project change to become unlikely to complete, the costs associated with that project are expensed. As of the end of the second quarter, \$180,000 of costs had been deferred (\$220,000 at the end of the preceding quarter). The change relates to the write-off of costs associated with two transactions that are not considered to be likely to close, as well as the amortization of costs relating to the ServerBeach acquisition.

## **Non-GAAP Measures**

The company reports Earnings Before Interest, Taxes, Depreciation and Amortization ("EBITDA"), which is an approximate measure of operating cash flow based on financial data from the company's income statement. EBITDA is not a recognized accounting measure nor is it defined by generally accepted accounting principles. This non-GAAP measure may not be an identical presentation when compared with other company reports, as the nature of amounts included in amortization varies. The disclosure of EBITDA is strictly presented for informational purposes and is not intended to replace financial results presented from operations or cash flow.

## **OUTLOOK AND RISKS**

### **Outlook**

The demand for high-speed, IP-based network services is growing rapidly, as both businesses and individual users place greater reliance on web-based information and applications. As a result, the industry segment that Peer 1 operates in is expected to continue along an upward growth trend as the demand for the outsourcing of secure internet infrastructure also grows.

Revenues are expected to continue their growth trend, though the growth rate is likely to fall because of the larger base. Current results have been impacted by rapidly declining internet bandwidth pricing. It is expected that prices will stabilize during FY2005, as a result of increased demand. Management has targeted \$16 million in revenues for 2005 from the colocation and bandwidth segment, and \$6 million in revenues from the dedicated server segment.

Costs of sales are expected to be significantly higher in the third and fourth quarters as a result of the addition of space in the Toronto and New York colocation facilities, and the move of ServerBeach equipment to the new Peer 1 facility. Until this additional capacity begins to generate sufficient revenues to break even, the outlook is for net losses in each of the third and fourth quarters. A net loss of just under \$3 million is projected for the year. However, EBITDA is expected to be over \$2 million, significantly higher than the \$0.9 million in the previous fiscal year.

## **Risks**

The company is subject to a number of business risks inherent in the industry, including competitive pressures, credit risk, foreign exchange risk and technological change.

Peer 1 operates in a competitive market. The company has differentiated itself from the competition by the high level of customer service we provide and the quality of the products we offer. Management intends to keep Peer 1's product offerings focused, so as to continue to deliver the high level of quality at a competitive price that the company has become known for. Our customer retention rate is one of the highest in the industry because of this customer and quality focus.

The company's bad debt rate has been reduced to 2-2.5% in the most recent fiscal year as a result of more sophisticated credit and collections procedures. This, together with the company's high retention rate of customers mitigates credit risk.

The company currently operates in Canada and the USA, and has recently established a POP the UK, and is thereby subject to risks typical of an international business including, but not limited to, differing economic conditions, differing tax structures, other regulations and restrictions and foreign exchange rate volatility. The company has evaluated its exposure to these risks, and has determined that its only significant exposure is to exchange rate risk with respect to the US dollar. At this time, costs denominated in US dollars exceed US denominated revenues. The company does not engage in hedging transactions, but anticipates that revenue growth in Peer 1's US locations, together with ServerBeach operations, will offset the exchange rate risk to a greater extent in 2005.

Technology is evolving rapidly, with the result that a major shift in communications technology away from the current IP based system could have a significant impact on all companies in the industry.

## **OTHER INFORMATION**

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