



NETWORK | CO-LOCATION | DEDICATED HOSTING

Management's Discussion & Analysis  
For The Fiscal Year Ended June 30, 2007



**MANAGEMENT'S DISCUSSION AND ANALYSIS  
OF FINANCIAL RESULTS  
FOR THE FISCAL YEAR ENDED JUNE 30, 2007**

*This Management Discussion and Analysis ("MD&A"), dated October 19, 2007, 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, 2007 and the notes thereto, all of which can be found on [www.sedar.com](http://www.sedar.com). Unless otherwise noted, all figures are in United States dollars.*

**FORWARD LOOKING STATEMENTS**

This 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. Peer 1 Network Enterprises Inc. ("Peer 1" or the "Company") disclaims any obligation to revise any forward looking statements as a result of information received after the fact or regarding future events.

**OVERVIEW**

**Fiscal Year Financial Highlights**

- Peer 1's revenue increased 22.45% to \$74.36 million for the year ended June 30, 2007, compared to \$60.73 million for the year ended June 30, 2006.
- Gross profit increased 28.08% to \$28.77 million for the year ended June 30, 2007, compared to \$22.46 million for the year ended June 30, 2006.
- Operating income increased 88.90% to \$7.61 million for the year ended June 30, 2007, compared to \$4.03 million for the year ended June 30, 2006.
- Income before income taxes was \$0.95 million for the year ended June 30, 2007, compared to a loss before income taxes of \$2.80 million for the year ended June 30, 2006.
- Net profit was \$3.63 million for the year ended June 30, 2007, compared to a net loss of \$3.19 million for the year ended June 30, 2006.

**Fiscal Year Key Developments**

- Effective May 29, 2007, Peer 1 closed a \$40 million amended and restated loan agreement with Fortress Credit Opportunities I LP. The loan agreement provides for two senior, secured credit facilities: (1) a \$20 million term loan to refund existing indebtedness; and (2) a \$20 million line of credit available to fund growth capital and acquisitions. The credit facilities will accrue interest at the rate equal to LIBOR plus an applicable margin. Management believes that with the cost of debt now significantly reduced and with secured access to a line

of credit, Peer 1 is now well positioned to aggressively pursue additional growth opportunities.

- During the year, in response to the growing demand for centrally located servers, and in order to keep up with its rapid growth, the Company completed a data center move and expansion of its available facilities in San Antonio. The new San Antonio data center has 12,000 square feet of raised floor space and an adjoining 6,000 square feet of office space. Additional expansions were made in Toronto and Vancouver.
- On February 1, 2007 the Company announced that recent expansions in current Peer 1 data centers across North America have given the Company the capacity to add approximately 65% more dedicated servers to its current base of over 16,000 dedicated servers and approximately 40% more co-location cabinet equivalents to its current base of over 1,100 cabinet equivalents. This will enable Peer 1 to significantly grow its customer base with modest incremental capital expenditures relative to building a new data center. The data center expansions and increased capacity supports management's strategy for continued growth and margin improvement.
- The Company was recognized as the ninth fastest-growing company in Canada and second in British Columbia in the 19th annual PROFIT 100 ranking of Canada's Fastest-Growing Companies by PROFIT Magazine. This is Peer 1's second consecutive year in the top ten of the PROFIT 100 list. In 2006 the company ranked fourth in Canada and came in as the number one fastest growing company in British Columbia.
- Peer 1 continued to enhance its product and service offering to support its organic growth strategy. In recent months, the Company, in partnership with industry leaders, introduced a number of quality products and services that leverage and complement the Company's current infrastructure.
  - In April 2007, Peer 1 completed the installation of the IBM Tivoli Storage Manager software, and is offering its managed dedicated hosting customers' world-class enterprise data backup services.

The Company's new Tivoli Data Backup solution is built on Peer 1's SAN technology, and gives customers storage management efficiencies by reducing file recovery time and disk consumption. The solution also allows Peer 1 to manage thousands of servers at one time, regardless of their geographical location. This is especially beneficial to the Company, which supports over 16,000 servers in 15 data centers across North America.

- In April 2007, the Company announced its partnership with ControlScan, a market leader in e-commerce security and marketing services. This partnership allows Peer 1 to offer its dedicated hosting customers an affordable solution for scanning their servers for the latest vulnerabilities. It also satisfies the rigorous payment card industry (PCI) compliance scan requirements.

Peer 1 utilizes ControlScan's award-winning, PCI-approved scanning solution to provide a safe platform from which their customers can perform online business. Peer 1 customers will be actively scanned for over 14,000 known vulnerabilities with a database that is updated twice daily. This will ensure their servers are safe and

protected from recent threats. This system will also allow Peer 1 customers to gain greater insight and management of their hosted server security.

- In May 2007 in accordance with the pre-existing terms of the Preferred Shares Series A, the holders of the 7,000 Preferred Shares Series A converted all 7,000 shares and cumulative compound unpaid dividends into 34,869,628 Common Shares of the Company.

## **OUR BUSINESS**

Peer 1 is a provider of Internet infrastructure solutions and related managed services. Peer 1's service offerings include bandwidth, co-location, and dedicated hosting services. The Company's customers are primarily a broad cross section of small- and medium-sized businesses across North America including community based hosting providers, online video gaming companies and Internet phone (VoIP) companies. Peer 1 has established datacenters and points of presence ("POPs") in 17 cities across North America and Europe including: Vancouver, Toronto, Montreal, New York, Seattle, San Jose, San Antonio, Los Angeles, Miami, Atlanta, Fremont, Herndon, Ashburn, Chicago, Dallas, Amsterdam and London, England.

Increased dependency on the Internet by business, technology enthusiasts and community based networks is driving the need for more IT infrastructure. Increased complexity of IT infrastructure is driving the need for outsourced service providers such as Peer 1. Management of Peer 1 believes that the Company has been successful in attracting and generating business as a result of offering:

- Cost savings
- 24 hours, 7 days a week monitoring
- Environmentally protected facilities
- High level of security
- Access to a high bandwidth, high quality IP network
- Customer support
- Scalability
- Backup and redundancy capabilities

### **Dedicated Servers**

Peer 1 provides competitively priced, managed and unmanaged dedicated server solutions to small and mid-size businesses. Managed dedicated hosting is a comprehensive web hosting service whereby the client is provided the ability to utilize a Peer 1 server or servers and related infrastructure and services housed in one of the Company's data centers, and receives professional managed support. The server is dedicated to the customer's use only. Unmanaged dedicated hosting is similar, but the customer performs the majority of management activities on the server. The acquisition of ServerBeach on October 20, 2004 and the dedicated server assets of Interland, Ltd. on September 2, 2005 significantly increased the Company's capacity to provide dedicated server solutions and product offerings that complement the Company's co-location and bandwidth service offerings.

### **Co-location**

Peer 1's co-location service involves the physical locating of a customer's switching gear and/or servers in one of the Company's data center facilities that provide the infrastructure necessary for

effective functioning of their equipment. The infrastructure resources include a secured cage or cabinet, regulated power, emergency backup power, dedicated Internet connection, regulated air temperature and physical security. Co-location customers are charged for the service provided by way of a monthly charge.

### **Bandwidth (Network)**

Peer 1's bandwidth service is provided by way of an expandable network through connections to multiple globally based providers in Canada, the US the UK and the Netherlands. Peer 1 utilizes 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.

## **STRATEGY**

Peer 1's growth strategy includes organic, leveraged, and accelerated growth. Organic growth focuses on the addition of new customers and the expansion of the network's reach into key peering points worldwide. Leveraged growth focuses on the introduction of new products and services that leverage and complement Peer 1's current infrastructure. Accelerated growth is based on pursuing investments and acquisitions complementary to existing lines of business.

### **Dedicated Servers**

Peer 1's strategy for dedicated servers is to provide Internet infrastructure built with quality parts and related services within a low cost framework that supports a value priced full customer solution. The Company, through its ServerBeach division specializes in offering self-managed dedicated servers where the client retains control of the functionality and performance of the server. Peer 1 Dedicated Hosting specializes in managed dedicated servers providing firewalls, storage area network, security and support to augment the client's applications, as well as, custom hosting solutions for clients with unique requirements.

### **Bandwidth (Network)**

Peer 1's strategy is to continue to build a series of dedicated links, peering relationships and establish traffic exchange agreements with other networks between the Company's facilities using multiple high-speed connections. Peering arrangements are fundamental to the Company's strategy, and create two advantages: first, they reduce latency between networks; and second, they avoid additional costs associated with a third party network. 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.

### **Co-location Facilities**

Peer 1 establishes a point of presence in new markets by co-locating in facilities owned by other suppliers. This allows Peer 1 to gauge market demand prior to establishing a new co-location facility. When a market is considered viable, the Company identifies suitable space for long term lease. Wherever possible, sites that have previously been operated as data centers are sought to

reduce initial capital investment requirements. Equipment is acquired and installed on a phased basis based on demand. As market share grows, additional space and equipment are acquired.

## SELECTED ANNUAL INFORMATION

(in \$ thousands, except per share items)	Year Ended June 30,		
	2007	2006	2005
<b>Statement of Operations Data</b>			
Dedicated Servers	52,960	42,335	5,811
Bandwidth	8,478	8,588	7,094
Colocation	9,901	7,919	5,556
Services	3,022	1,884	977
<b>Total Revenue</b>	<b>74,361</b>	<b>60,726</b>	<b>19,438</b>
Total Cost of Sales	45,594	38,266	11,889
Gross Profit	28,767	22,460	7,549
Total Operating Expenses	21,153	18,430	7,225
Operating Income (Loss)	7,614	4,030	324
Non-Operating expenses:	6,661	6,828	2,506
Income Taxes	(2,678)	390	-
<b>Net Income (Loss)</b>	<b>3,631</b>	<b>(3,188)</b>	<b>(2,182)</b>
Net Income (Loss) per share (basic & diluted)	0.04	(0.04)	(0.04)
<b>Balance Sheet Data</b>			
Cash (including Restricted cash)	9,259	6,171	792
<b>Current Assets</b>	<b>17,981</b>	<b>12,133</b>	<b>3,621</b>
<b>Total Assets</b>	<b>54,086</b>	<b>48,283</b>	<b>19,557</b>
Current portion of notes payable	3,350	3,664	10,992
Current Liabilities	17,039	17,938	19,023
Deferred gain	650	-	-
Deferred lease inducements	965	423	314
Notes Payable	16,257	17,388	95
Long Term Debt	-	8,087	-
Total Liabilities	34,911	43,836	19,432
Shareholders' Equity	19,175	4,447	125
<b>Total Liabilities &amp; Shareholders' Equity</b>	<b>54,086</b>	<b>48,283</b>	<b>19,557</b>

## RESULTS OF OPERATIONS

### Acquisitions

Over the past three years, Peer 1's strategic focus has expanded through the execution of a three-pronged growth strategy to grow and diversify the Company's sources of revenue.

In FY2004, Peer 1's primary focus was on providing bandwidth and co-location services, which represented over 94% of the Company's consolidated revenue. In FY2006, bandwidth and co-

location revenues represented 27% of consolidated revenues, while dedicated server revenue accounted for 70% of consolidated revenues. For the same period in FY2007, bandwidth and co-location revenues represented 25% of consolidated revenues, while dedicated server revenue accounted for 71% of consolidated revenues. The shift in sources of revenue is attributable to the FY2005 acquisition of ServerBeach Ltd. and FY2006 acquisition of dedicated hosting assets from Interland, Inc. (the “Dedicated Hosting” acquisition) as described below.

On September 2, 2005, the Company acquired the dedicated server assets of Interland, Inc for \$14.0 million. Included in the operating assets were existing customer contracts and data centers in Atlanta, GA; Fremont, CA; and Miami, FL.

## Revenues

The Company’s business model is based on recurring revenue streams for all of its main offerings. Customer revenue from services and product offerings, which are invoiced monthly, generally continue on a go forward basis with a manageable level of customer churn. Customer contracts range from month-to-month to three year terms.

Services revenue includes additional charges for power and set-up fees for initial configuration and installation of services. Set up fees are typically billed once and only upon completion of such configuration and installation.

	Twelve Months ended June 30			
	2007	%	2006	%
Revenue:				
Colocation	9,900,729	13%	7,919,387	13%
Bandwidth	8,478,286	12%	8,588,209	14%
Services	3,022,225	4%	1,883,887	3%
Dedicated Servers	52,959,588	71%	42,335,030	70%
<b>Total Revenue</b>	<b>\$ 74,360,828</b>	<b>100%</b>	<b>\$ 60,726,513</b>	<b>100%</b>

Consolidated revenue increased to \$74.36 million for the year ended June 30, 2007 from \$60.73 million for the year ended June 30, 2006. The increase in revenue for the year is attributable to organic growth as well as to twelve months of revenue from Dedicated Hosting compared to ten months of revenue from Dedicated Hosting during the same period last fiscal year.

Co-location revenues increased to \$9.90 million in the year ended June 30, 2007 from \$7.92 million for the year ended June 30, 2006. The increase is attributable to improved pricing and increased sales volume. As the Company continues to pursue its organic growth strategy, the Company expects the data center expansion in Vancouver and Toronto and the resultant increase in co-location capacity to continue to generate incremental revenue in future periods.

Bandwidth revenues remained stable at \$8.5 million in the year ended June 30, 2007 compared to \$8.6 million in the year ended June 30, 2006. The bandwidth business line continues to operate in a competitive, price sensitive market.

Dedicated server revenues increased to \$52.96 million for the year ended June 30, 2007 from \$42.34 million for the year ended June 30, 2006. The increase for the year is attributable to

increased sales, addition of new customers, an overall decrease in customer churn rates and twelve months of revenue from Dedicated Hosting for the year ended June 30, 2007, compared to ten months of revenue from Dedicated Hosting during the same period last fiscal year.

The Company's Canadian operations accounted for \$15.77 million of revenues in the year ended June 30, 2007 compared to \$14.16 million of revenues in the year ended June 30, 2006. This change is the result of increased co-location revenues in the Canadian operations for the year compared to the same period last year. The Company's Canadian operations accounted for 21% of revenues in the year ended June 30, 2007 compared to 23% of revenues in the year ended June 30, 2006. The revenues generated by US operations grew at a slightly faster rate than the revenues generated by Canadian operations resulting in a 2% shift in revenues from Canadian operations to US operations.

### **Cost of Sales**

Cost of sales for the Company is primarily fixed and relate to infrastructure and staffing. Infrastructure costs consist of rent, maintenance, power, cooling, security, leasing and/or amortization of equipment and improvements, insurance, software licenses and supplies. Variable costs consist of power consumption, and incremental bandwidth from upstream carriers.

Consolidated cost of sales increased to \$45.59 million for the year ended June 30, 2007 from \$38.27 million for the year ended June 30, 2006. Cost of sales as a percentage of revenue decreased to 61.31% for the year ended June 30, 2007 compared to 63% for the same period in 2006. Cost of sales for the current year includes approximately \$0.30 million of one time supplemental facilities charges. The cost of sales dollar increase for the year ended June 30, 2007 is primarily a result of the inclusion of the operations relating to the acquired assets from Interland, Inc. for an additional two months compared to the same period in the prior fiscal year in addition to increased costs related to increased sales levels and data center expansions.

In the year ended June 30, 2007, in order to better reflect their functional contribution to the Company, costs associated with certain technical staff at Dedicated Hosting were reclassified from cost of sales to operating expenses, specifically technology and customer relations. Accordingly, cost of sales figures for the years ended 2007 and 2006, discussed above, have been reclassified on a comparative basis.

For the year ended June 30, 2007, cost of \$1.4 million was reclassified from cost of sales to operating expenses compared to \$1.0 million for the same period last year.

Total cost of sales is expected to increase as revenues increase. The pattern of growth in revenues related to the new facilities does not generally match the pattern of growth in the related costs. Revenue increases are a function of capacity utilization. The cost of sales related to co-location is primarily affected by the cost of facilities. The cost of sales related to bandwidth is primarily affected by cost for bandwidth, transport and infrastructure. The cost of sales related to the dedicated server line of business is primarily affected by the costs of facilities, costs of servers and bandwidth costs.

### **Operating Expenses**

The following table presents operating expenses consisting of sales and marketing, general and administrative and technology and customer relations, as a percentage of revenue.

	Twelve Months ended June 30			
	2007	%	2006	%
Total Operating Expenses	\$ 21,153,556	28%	\$ 18,429,773	30%

Total operating expenses increased to \$21.15 million for the year ended June 30, 2007 from \$18.43 million for the year ended June 30, 2006. Operating expenses as a percentage of revenue decreased to 28% in the year ended June 30, 2007 from 30% for the year ended June 30, 2006. The significant increase in operating expenses for the year ended June 30, 2007 compared to the same period in the prior fiscal year is a result of twelve months of operating expenses from Dedicated Hosting for the year ended June 30, 2007, compared to ten months of operating expenses from Dedicated Hosting during the same period last fiscal year and a one-time cost of \$0.9 million that is attributable to a change in estimate related to sales and use tax amounts payable. The sales and local tax provision has been based primarily on taxing position and assessment provided to the Company. The Company is reviewing the information and is considering a ruling and/or an appeal in connection with this matter.

As well, as discussed in cost of sales above, costs associated with certain technical staff at Dedicated Hosting were reclassified from cost of sales to operating expenses. Please refer to the discussion of cost of sales above on the reclassification of costs related to certain technical staff from cost of sales to operating expenses. Operating expenses for the twelve months ended June 30, 2007 and June 30, 2006 are presented on the basis of having reclassified the same amounts for respective periods as has been done for cost of sales.

The largest component of operating expenses is general and administrative which accounted for 62% for the year ended June 30, 2007 compared to 65% for the year ended June 30, 2006. The decrease in general and administrative expenses as a percentage of operating expenses for the year ended June 30, 2007 compared to the same period June 30, 2006 is attributable to increased expenses in sales and marketing and technology and customer relations to support growth and the effect of having decreased the allowance for doubtful accounts during the year ended June 30, 2007 to reflect a more current customer accounts receivable aging primarily as a result of sustained collection efforts. Management continues to focus on administration costs to ensure that operations are as efficient as possible and it is anticipated that they will be reduced as a percentage of revenue over time.

Sales and marketing costs accounted for 25% for the year ended June 30, 2007 compared to 24% for the year ended June 30, 2006. The increase for the year ended June 30, 2007 is a result of increased marketing efforts 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**

The Company is currently incurring expenses related to the integration of the Dedicated Hosting acquisition. The Company incurred \$0.65 million in integration expenses in the year ended June 30, 2007 as compared to \$1.19 million in the year ended June 30, 2006. The Company anticipates reduced expenses for these activities to continue through the next fiscal year. Integration costs include the cost of a new billing, ticketing and customer support system in addition to separation of business operations. Also during the year, the Company recorded an amount of \$1.18 million

with respect to an impairment provision on capitalized internally developed software. Events and circumstances indicated that the carrying value of these assets was not recoverable over their remaining lives and the assets were considered to have no future benefit to the Company.

### **Income Tax Expense (Recovery)**

In the twelve months ended June 30, 2007, the Company recorded an income tax benefit of \$3.97 million primarily due to the reduction of the valuation allowance on future income tax assets. The reduction in the valuation allowance was based upon a number of factors, including the Company's recent history of profitability and ability to utilize non-capital loss carry forwards, an analysis of the expected timing of reversals of temporary differences and budgeted and forecasted earnings, after adjusting for non-deductible expenditures. Although realization is not assured, the Company believes it is more likely than not that certain future tax assets will be realized and therefore a benefit has been recorded. In future periods, income tax expense will be recorded based on the Company's expected statutory tax rate adjusted for permanent items. This will be subject to periodic assessments of the valuation allowance which could result in increases or decreases to the future tax asset and income tax expense.

### **Liquidity and Capital Resources**

Peer 1 has historically financed operations through cash generated from operations, sale of common and preferred shares and issuance of debt. As at June 30, 2007, the Company had cash, cash equivalents and short term investments of \$9.3 million (including \$0.5 million in restricted cash – see Off-Balance Sheet Arrangements section), compared to \$6.1 million (including \$0.5 million in restricted cash) as at June 30, 2006. The Company had long term debt in the form of notes payable of \$19.6 million as at June 30, 2007 compared to \$21.0 million of notes payable as at June 30, 2006. In May 2007 in accordance with the pre-existing terms of the Preferred Shares Series A, the holders of the preferred shares converted all preferred shares and cumulative compound unpaid dividends into Common Shares of the Company. As a result, long term debt in the form of preferred shares was nil as at June 30, 2007 compared to \$8.1 million as at June 30, 2006.

The Company had a working capital deficit of \$1.3 million at June 30, 2007 compared to a working capital deficit of \$5.8 million as at June 30, 2006. The improvement in working capital is a result of the Company's re-capitalization in conjunction with the Dedicated Hosting acquisition, as described below.

The working capital deficit of \$1.3 million at June 30, 2007 includes deferred revenue of \$4.2 million and current portion of notes payable of \$3.3 million. The Company anticipates current liquidity and cash generated from operations to be sufficient to fund existing operations for the foreseeable future.

### **Loan Renegotiation**

On May 25, 2007 Peer 1 entered into a US\$40 million amended and restated loan agreement with Fortress Credit Opportunities I LP, ("Fortress") of which US\$20 million has been advanced. The loan agreement (the "amended and restated LSA") is by and among Peer 1 Network (USA), Inc. and each of its subsidiaries that are signatories thereto as borrowers (the "Borrowers"), the Company and each of its subsidiaries that are signatories thereto as guarantors (the "Guarantors"), Fortress as the lender, and Fortress Credit Corp. as the arranger and administrative agent.

Pursuant to the LSA, Fortress agreed to make two senior secured credit facilities (the “Credit Facilities”) available to the Borrowers: a term loan (the “Term Loan”) in the amount of US\$20 million; and a line of credit facility (the “Line”), in the maximum amount of US\$20 million.

#### The Term Loan

On May 29, 2007 (the “Closing Date”), the Term Loan was fully advanced in the amount of US\$20 million. The advances were comprised of the aggregate principal outstanding under previous term loan facilities with Fortress Credit Corp. totaling approximately \$18,130,943.99 as at the Closing Date (initially advanced in 2005), together with such additional principal as is necessary to bring the total principal amount outstanding as at the Closing Date to US\$20 million. The Term Loan has a term of three years and is repayable in payments of \$266,667 per month. The credit facility shall terminate and all loans and other obligations outstanding shall be payable in full on the third anniversary of the Closing Date (the “Maturity Date”), subject to the option for Peer 1 to extend the credit facility for an additional two years upon giving no less than 90 days’ notice to Fortress before the Maturity Date.

#### The Line

The Line has been made available to the Borrowers in order to finance future acquisitions and growth capital expenditures. Borrowings under the Line can be made up to US\$20 million provided that as of the date of any borrowing, after giving effect to the requested borrowing, the Borrowers’ total funded debt outstanding under the Term Loan and the Line does not exceed 2.5 times actual trailing twelve month EBITDA (“TTM EBITDA”) as defined under the terms of the agreement. There is an annual standby fee of one-half of one percent of the difference between the monthly balance of the Line commitment amount and the outstanding borrowings under the Line, payable 1/12th monthly. Draws under the Line will amortize monthly based upon the following schedule:

Year 1: 1.25% of the outstanding balance;  
Year 2: 2.0% of the outstanding balance; and  
Year 3: 2.0% of the outstanding balance.

The Borrowers will repay the entire unpaid principal balance of the credit facility, including amounts owing under the Line, on the Maturity Date. The Borrowers shall have the ability, at their option, to terminate the Line on the first anniversary of the Closing Date if no advances have been made under the Line during that period. The Line will automatically terminate on the second anniversary of the Closing Date if no advances have been made under the facility during that time. As of June 30, 2007, no advances have been made under the Line.

#### Security

The Credit Facilities are secured by a first priority lien on all assets of the Borrowers including, but not limited to, capital, stock, accounts receivable, inventory, property, plant and equipment and all real and personal property owned and used by the Borrowers in connection therewith, intangible assets, trade-marks, brands and all products and proceeds thereof.

## Loan Prepayments

A portion of the net proceeds received by any of the Borrowers from the issuance of equity securities must be used to prepay the loan. Additionally, the proceeds from the sale of any assets in excess of \$250,000 in a fiscal year must be used to prepay the loan.

## Interest Rate

Obligations under the Credit Facilities will accrue interest at the rate equal to the greater of (a) 30-day LIBOR, or (b) three percent, plus the percent per annum equal to the Applicable Margin set forth below:

Total Debt / actual TTM EBITDA	Applicable Margin
> 2.00x, <= 2.50x	4.25%
> 1.00x, <= 2.00x	3.25%
<= 1.00x	3.00%

## Preferred Share Conversion

In May 2007 in accordance with the pre-existing terms of the Preferred Shares Series A, the holders of the 7,000 Preferred Shares Series A converted all 7,000 shares and cumulative compound unpaid dividends into 34,869,628 Common Shares of the Company. The conversion of the Preferred Shares Series A was calculated based on dividing the face value of \$1,000 for each preferred share plus the cumulative compound unpaid dividends totaling \$988,631 by \$0.2291. As a result of the conversion, the carrying value of the Preferred Shares Series A classified as long term debt has, following the conversion, been classified to Common Shares.

## Operating Activities

Cash flow from operating activities for the year ended June 30, 2007 and 2006 was \$14.33 million and \$16 million, respectively. The decrease in cash provided by operations in the year ended June 30, 2007 compared to the same period last year resulted primarily from improvement in the Company's operating results as well as overall improvement in its working capital balances offset by decrease in accounts payable and accrued liabilities related to the timing of invoice payments as at year end and decrease in receivables related to the timing of receipts as at year end. Excluding changes in non-cash working capital items, cash flow from operating activities for the year ended June 30, 2007 and 2006 was \$15.4 million and \$11.1 million, respectively.

Implementation of one or more of the Company's growth strategies, combined with the continued integration of Peer 1 Dedicated Hosting, may have short-term negative impact on its expenses and cash flow from operations.

## Investing Activities

Cash used for investing activities for the year ended June 30, 2007 and 2006 was \$12.8 million and \$29.8 million, respectively. The decrease in use of cash for the twelve month period ended June 30, 2007 compared to the same period last year was a result of the purchase of Interland's dedicated server assets on September 2, 2005.

## Financing Activities

Net cash inflows from financing activities for the year ended June 30, 2007 was \$1.6 million compared to cash inflows from financing of \$19.2 million for the year ended June 30, 2006. The decrease in cash provided by financing activities for the year ended June 30, 2007 compared to the same period last year is a result of the financings and re-capitalization undertaken in conjunction with the acquisition of the dedicated server assets from Interland in September 2005.

Cash provided by financing activities in the year ended June 30, 2007 resulted from \$1.8 million net proceeds received from the sale leaseback of the leased data centre property in Miami in September 2006 as well as from \$1.4 million received from the issuance of share capital, offset by \$1.6 million expended on repayment of notes payable and long-term debt net of proceeds.

## OFF-BALANCE SHEET ARRANGEMENTS

As of June 30, 2007 Peer 1 has provided two letters of credit totaling US\$0.5 million as security to a landlord for a facility lease and for a major supplier. The security for the facility lease will be required for the term of the lease, whereas the security for the suppliers is dependant on whether the Company continues to use the same suppliers, the extent to which a sufficient credit history is established with the suppliers to reduce or negate the need for such security, and other similar discretionary factors. The letters of credit are secured by way of term deposits which are included in the reported cash balance. The financial statements classify these term deposits as restricted cash.

## TRANSACTIONS WITH RELATED PARTIES

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

At June 30, 2007 amounts due to and from related parties were as follows:

	<b>FY2007</b>	<b>FY2006</b>
Accounts receivable from related companies	\$10,097	\$59,158
Accounts payable to related parties	\$35,001	\$25,947

During the twelve month period ending June 30, 2007 transactions with related parties were as follows:

	<b>FY2007</b>	<b>FY2006</b>
Revenues earned by the Company from related parties	\$97,713	\$169,435
Interest expensed by the Company	-	\$322,174
Other expenses incurred by the Company	\$454,022	\$365,322

These transactions are in the normal course of operations and are measured at their exchange amounts. Other expenses incurred include fees in the amount of \$435,683 for management and consulting services provided by related parties.

Details of related party transactions for the 12 months ended June 30, 2007

Related person or entity	Related person	A/R	A/P	USD Revenue	Interest	Other
Celerity Partners	Mark Benham	-	-	-	-	3,840
Code Marketing Ltd.	Lance Tracey	-	24,873	-	-	322,538
DA Harrison & Associates	David Harrison	-	-	-	-	6,785
E-Xact Transactions Ltd.	Scott Shaw, Lance Tracey	-	-	-	-	1) Revenue from contract to provide colocation and bandwidth in Vancouver US\$60,817...2) E-Xact provides Peer 1 with credit card gateway processing services US\$1,630
		6,200	178	60,817	-	1,630
Fatport	Michael Cytrynbaum	1,607	-	8,170	-	-
Pubsub Concepts Inc.	Lance Tracey	-	-	21,625	-	12,869
		-	-	53	-	-
Sutton Group Financial Services Ltd.	Scott Shaw, Lance Tracey	-	-	7,049	-	-
Sutton Group Realty Services Ltd.	Scott Shaw, Lance Tracey	2,289	9,949	-	-	106,361
		-	-	-	-	Revenue from contract to provide colocation service, US\$53
		-	-	-	-	Consulting expenses CDN\$10000 per month
		10,097	35,001	97,713	-	454,022

## SUMMARY OF QUARTERLY RESULTS

The following table sets out certain operating results of the Company for the past eight quarters.

	Quarter Ended (in thousands \$)							
	30-Sep	31-Dec	31-Mar	30-Jun	30-Sep	31-Dec	31-Mar	30-Jun
	2005	2005	2006	2006	2006	2006	2007	2007
	(US\$)	(US\$)	(US\$)	(US\$)	(US\$)	(US\$)	(US\$)	(US\$)
Revenue	9,678	16,287	17,627	17,134	17,486	18,131	18,812	19,932
Operating Profit (Loss)	1,095	1,074	1,224	638	1,772	2,284	1,972	1,586
Net Income (Loss)	(1,018)	(481)	(355)	(1,333)	249	849	230	2,303
Basic income (loss) per share	(0.02)	(0.01)	(0.01)	(0.01)	0.00	0.01	0.00	0.02
Fully diluted income (loss) per share	(0.02)	(0.01)	(0.01)	(0.01)	0.00	0.01	0.00	0.02

## FOURTH QUARTER RESULTS

	Three months ended June 30			
	2007	%	2006	%
Revenue:				
Colocation	2,674,639	13%	2,210,314	13%
Bandwidth	2,286,110	12%	2,333,647	14%
Services	939,453	5%	443,222	3%
Dedicated Servers	14,031,130	70%	12,147,569	71%
<b>Total Revenue</b>	<b>\$ 19,931,332</b>	<b>100%</b>	<b>\$ 17,134,752</b>	<b>100%</b>

Revenues for the fourth quarter of 2007 increased \$2.8 million to \$19.9 million, from \$17.1 million in the same quarter a year ago. The increase in revenue is primarily attributable to organic growth. Revenue mix for the quarter was 70% dedicated hosting, 13% co-location, 12% bandwidth and 5% from services.

Consolidated cost of sales increased to \$11.9 million for the three months ended June 30, 2007 from \$10.8 million for the three months ended June 30, 2006. Cost of sales as a percentage of revenue decreased to 60% for the year ended June 30, 2007 compared to 63% for the same period

in 2006. As discussed in annual results of operations above, total cost of sales is expected to increase as revenues increase.

Operating expenses as a percentage of revenue decreased to 32% compared to 33% in the same quarter a year ago. During the quarter the Company incurred certain one-time costs including: \$0.9 million that is attributable to a change in estimate related to sales and local tax amounts payable, \$0.1 million severance expenses and \$0.2 million insurance expenses.

As discussed in annual results of operations above, costs associated with certain technical staff at Dedicated Hosting were reclassified from cost of sales to operating expenses. Cost of sales and operating expenses discussed above for the three months ended June 30, 2007 and June 30, 2006 are presented on the basis of having reclassified the same amounts for cost of sales as has been done for operating expenses.

During the quarter ended June 30, 2007, the Company recorded an amount of \$1.18 million with respect to an impairment provision on capitalized internally developed software. Events and circumstances indicated that the carrying value of these assets was not recoverable over their remaining lives and the assets were considered to have no future benefit to the Company.

In the three months ended June 30, 2007, the Company recorded an income tax benefit of \$3.6 million primarily due to the reduction of the valuation allowance on future income tax assets. The reduction in the valuation allowance was based upon a number of factors, including the Company's recent history of profitability, an analysis of the expected timing of reversals of temporary differences and the budgeted and forecasted earnings, after adjusting for non-deductible expenditures. Although realization is not assured, the Company believes it is more likely than not that certain future tax assets will be realized and therefore a benefit has been recorded. In future periods, income tax expense will be recorded based on the Company's expected statutory tax rate adjusted for permanent items. This will be subject to periodic assessments of the valuation allowance which could result in increases or decreases to the future tax asset and income tax expense.

## **SUBSEQUENT EVENTS AND PROPOSED TRANSACTIONS**

- On September 4, 2007, Peer 1 and Juniper Networks, Inc. the leader in high-performance networking announced that Peer 1 has expanded its managed firewall service offerings with the addition of Juniper Networks Secure Services Gateways (SSGs). Fully managed by Peer 1 experts, the Juniper Networks SSG platforms will provide best-in-class protection, superior capacity and Gigabit Ethernet interfaces, enabling Peer 1 to offer cost-effective, high-capacity security solutions that scale to meet the demands of the largest enterprises. The expanded managed firewall services ensure a secure and trusted network environment without requiring enterprise customers to dedicate IT resources, enabling customers to reduce operational costs and complexity.

The Juniper Networks SSG appliances are purpose-built firewalls that deliver a blend of performance and security. Managed by Peer 1 experts, these systems are optimized to protect Peer 1's managed hosting. Peer 1 will customize these appliances to match a customer's specific security needs, leveraging the SSG product line to offer a range of scale options to meet the needs of businesses of all sizes.

- On September 10, 2007 the company announced several changes of roles for members of the company executive management team.

Lance Tracey, co-founder and chief executive officer, has announced that he is stepping down from his role as CEO. Effective immediately, Mr. Tracey will assume his new role as executive chairman of Peer 1's board of directors.

Fabio M. Banducci has been appointed the Company's new CEO in addition to his existing role as president of Peer 1.

Gary Sherlock, Peer 1's chief financial officer, has been promoted to the role of executive vice president in addition to his CFO responsibilities.

- September 25, 2007— the company announced that it has deployed EMC Storage Area Network (SAN) platforms across all of its managed dedicated hosting data center operations in Atlanta, Miami, and Fremont, California (Silicon Valley). The EMC platform provides state-of-the-art technology to optimize Peer 1's data backup solution, providing managed dedicated hosting customers with faster and more reliable backup and data recovery.

The data backup service from Peer 1 provides customers with either daily or weekly backup options of local server storage to the EMC Storage Area Network in a highly secure area of the Peer 1 data centers. Peer 1's backup and data recovery solutions are fully managed by internal Peer 1 data backup experts and support professionals.

In addition to backup services, the EMC storage solution allows Peer 1 to offer highly available mass storage options to customers over 4Gbit Fiber Channel connections. This external storage will provide additional scaling options to Peer 1 customers that have traditionally been limited to local server storage.

- On October 3, 2007, Peer 1 announced that the Company is now offering the latest SWsoft Plesk 8.2 for Linux control panel software for its managed hosting customers.

Plesk provides server administrators with a simple yet powerful tool to manage their servers and websites. Plesk 8.2 also includes an intuitive interface that allows users without a technical background to create new email accounts and manage domains.

The Plesk control panel automates a large number of tasks to help service providers reduce operating costs and resources. The new feature set also includes additional skins and the ability to customize, along with improved security via a redesigned subsystem and support for third-party FTP servers to assist with secure uploads.

## **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, 2007 115,994,291 common shares were issued and outstanding. As of the date of this MD&A 118,150,795 common shares were issued and outstanding.

At June 30, 2007 5,077,404 warrants for the purchase of shares ranging in price from US\$0.23 to CAD\$0.40 (approximately US\$0.3754) were outstanding. As of the date of this MD&A 1,937,500 warrants have been exercised and Nil warrants have been issued subsequent to the end of the quarter.

As at June 30, 2007 9,547,004 stock options were outstanding under the Company's stock option plan. Subsequent to the year ended June 30, 2007 and as of the date of this MD&A, 219,004 options were exercised and 45,000 additional options have been granted. Stock options outstanding as of the date of this MD&A are 9,373,000.

If all warrants and options were exercised there would be a total of 130,663,699 shares outstanding as of the date of this MD&A.

### **CRITICAL ACCOUNTING ESTIMATES**

Management makes certain estimates in order to report the Company's financial position and results of operations. Such estimates include the collectability of accounts receivable, the useful life of fixed assets, the likelihood of M&A projects being completed (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 customers as well as overall historical collection trends. Our allowance varies by line of business and ranges from approximately 1-2.5% of annual revenues in the bandwidth and co-location business and approximately 1% in the dedicated hosting lines of business.

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

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

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

### **RECENT ACCOUNTING CHANGES**

In January 2005, the CICA released new Handbook Section 3855, Financial Instruments, Recognition and Measurement, effective for annual and interim periods beginning on or after October 1, 2006. This new section establishes standards for the recognition and measurement of all financial instruments, provides a characteristics-based definition of a derivative financial instrument, provides criteria to be used to determine when a financial instrument is to be extinguished. As a result, effective July 1, 2007 the Company will record certain financial instruments on the balance sheet at fair value, with changes in fair value recognized in income or other comprehensive income, as appropriate, each period.

In January 2005, the CICA released new Handbook Section 1530, Comprehensive Income and new Handbook Section 3251, Equity, both effective for annual and interim periods beginning on or after October 1, 2006. Section 1530 establishes standards for reporting comprehensive income. It defines other comprehensive income to include revenues, expenses, gains and losses

that, in accordance with primary sources of GAAP, are recognized in comprehensive income, but excluded from net income. The Section does not address issues of recognition or measurement for comprehensive income and its components. Section 3251 establishes standards for the presentation of equity and changes in equity during the reporting period. The requirements in Section 3251 are in addition to Section 1530 and recommend that an enterprise should present separately the following components of equity: retained earnings, accumulated other comprehensive income, and the total for retained earnings and accumulated other comprehensive income, contributed surplus, share capital and reserves. The adoption of these standards effective July 1, 2007 is not expected to have a significant impact on the Company's financial statements.

In January 2005, the CICA released new Handbook Section 3865, Hedges, effective for annual and interim periods beginning on or after October 1, 2006. This new Section establishes standards on when and how hedge accounting may be applied. The adoption of this standard effective July 1, 2007 is not expected to have an impact on the Company's financial statements.

In December 2006, the CICA released new Handbook Section 1535, Capital Disclosures, effective for annual periods beginning on or after October 1, 2007. Section 1535 establishes standards for disclosing information about an entity's capital and how it is managed. It requires the disclosure of information about an entity's objectives, policies and processes for managing capital. The Company will adopt this standard for its 2008 fiscal year.

In December 2006, the CICA released new Handbook Section 3862, Financial Instruments – Disclosures and Handbook Section 3863, Financial Instruments – Presentation effective for annual and interim periods beginning on or after October 1, 2007. Section 3862 requires entities to provide disclosures in their financial statements that enable users to evaluate the significance of financial instruments on the entity's financial position and its performance and the nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the balance sheet date, and how the entity manages those risks. Section 3863 establishes standards for presentation of financial instruments and non-financial derivatives. It deals with the classification of financial instruments, from the perspective of the issuer, between liabilities and equities, the classification of related interest, dividends, losses and gains, and circumstances in which financial assets and financial liabilities are offset. The Company will adopt these standards in its 2008 fiscal year.

## CONTROLS AND PROCEDURES

The Chief Executive Officer and the Chief Financial Officer of the Company have evaluated the effectiveness of the Company's disclosure controls and procedures as of the end of the year ended June 30, 2007 and have concluded that these disclosure controls and procedures, as defined in Multilateral Instrument 52-109 – Certification of Disclosure in Issuers' Annual and Interim Filings, are effective and that material information relating to the Company was made known to them and was recorded, processed, summarized and reported within the time periods specified under applicable securities legislation.

Management is also responsible for the design of internal controls over financial report (“ICOFR”) within the Company in order to provide reasonable assurance regarding the reliability of financial reporting and the preparation of the financial statements for external purposes in accordance with Canadian GAAP. Management has evaluated whether there were changes to its ICOFR during the year ended June 30, 2007 that have materially affected, or are reasonably expected to materially affect, its ICOFR. No such changes were identified.

## **ACCOUNTING POLICIES**

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

## **RISKS**

### **Operating Results are Expected to Fluctuate**

The Company has experienced fluctuations in its operating results on a quarterly and on an annual basis. In view of the rapidly evolving nature of the Company's business, and the risk explained herein and those that are included in filings with regulatory authorities, the Company believes that period-to-period comparisons should not be relied upon as an indication of future performance. The Company expects that operating results will continue to fluctuate in the foreseeable future due to a variety of factors, including but not limited to:

- changes in general economic conditions and specific market conditions in the telecommunications and Internet industries;
- the timing and magnitude of operating expenses, capital expenditures and expenses relating to the expansion of sales, marketing, operations and acquisitions, if any, of related or complementary businesses and assets;
- the cost and availability of adequate public utilities, including power; and
- certainty that customer contracts will be renewed upon expiry.

Any of the foregoing factors could have material adverse effect on the Company's business, results of operations or financial condition.

### **Competition**

The Company operates in a competitive market. The company competes on the basis of certain factors including the ability to provide its customers with scalable Internet operations and infrastructure, the use of private backbone connections and the ability to provide redundant, high-speed connectivity to the Internet. There is no assurance the Company's current and future competitors will not be able to develop co-location services, dedicated servers or other infrastructure expertise comparable or superior to those developed by the Company or to adapt more quickly than the Company to new technologies, evolving industry standards or customer requirements. Certain of Peer 1's competitors or potential competitors have or may have far greater financial resources, brand recognition and established business relationships with enterprises in Peer 1's target market than Peer 1 at the present time.

### **Price Sensitive Market**

Peer 1's offerings are currently priced on a value basis. However, the competitive market in which Peer 1 conducts its business could require the Company to reduce its prices. If Peer 1'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 prices or offer other

favorable terms to compete successfully. Any such changes would likely reduce Peer 1's margins and could adversely affect operating results.

### **Currency Fluctuations**

The Company's revenues and costs are affected by fluctuations in the rate of exchange between the Canadian dollar and the U.S. dollar. Exposure to exchange rate fluctuations exists because a portion of the Company's revenues, trade receivable and trade payables are in Canadian and US dollars depending on the location of business. The Company expects that Canadian and US dollar sales and expenses will continue to account for a material portion of operations for the foreseeable future. As a result, exchange rate fluctuations may affect the Company's revenue and earnings growth materially in the future.

### **Dependence on Key Suppliers**

The Company's operations are dependent on the timely delivery of materials by outside suppliers. While the Company enters into purchase agreements with a few of its suppliers, the Company cannot be sure that materials, components, and subsystems will be available in quantities required, if at all. If any of the suppliers fail to meet the Company's needs, it may not have readily available alternatives. The Company's inability to fill its supply needs would jeopardize its ability to satisfactorily complete the Company's obligations under its contracts on a timely basis. This might result in reduced sales, contractually imposed penalties for delay of services, termination of one or more of these contracts or damage to the Company's reputation and relationships with its customers. All of these events could have negative impact on the Company's financial condition.

### **Integration Risk of Acquisitions**

The Company may pursue strategic relationships, investments and acquisitions. The Company may not be able to successfully manage its operations if it fails to successfully integrate the acquired technologies and/or businesses. The risks commonly encountered in the creation (execution) of a strategic relationship, investment in or acquisition of businesses would accompany any future investments or acquisitions by the Company. Such risks may include the following:

- issues related to product transition (such as development, distribution and customer support);
- the substantial management time devoted to such activities;
- the potential disruption of the Company's on-going business;
- undisclosed liabilities;
- failure to realize anticipated benefits (such as synergies and costs savings);
- the difficulty in integrating potentially distinct businesses into one business unit; and
- technological uncertainty regarding the current and future functionality of products and services.

### **OTHER INFORMATION**

Additional information relating to Peer 1 is available on SEDAR at [www.sedar.com](http://www.sedar.com).