

PEER 1 NETWORK ENTERPRISES INC. MANAGEMENT DISCUSSION & ANALYSIS FOR THE YEAR ENDED JUNE 30, 2004

This Management Discussion and Analysis ("MD&A"), dated September 24 2004, should be read in conjunction with Peer 1's 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 associated with the business and the economic environment the business operates. 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

Annual Highlights

- 37% increase in annual revenues (twelve months ended June 30, 2003 vs twelve months ended June 30, 2004) from \$9.9 million to \$13.6 million.
- Gross profit margins increase from 22% to 36%.
- \$2.3 million improvement in the bottom line from loss of \$3.3 million to loss of just under \$1 million.
- 47% increase in customers, now exceed 750.
- 125% increase in bandwidth traffic volume
- Introduced PIX - a unique, free peering exchange
- Entered into a Joint Venture (Symmetric Broadband) in the flourishing VoIP (Voice over IP) industry, which leverages Peer 1's existing infrastructure.
- Opened two new carrier neutral data centres – one in Toronto and one in Vancouver

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.

Co-location

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

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

STRATEGY

Peer 1 Network Enterprises, Inc. management has developed a well defined 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.

Co-location Facilities

Peer 1's strategy is to establish a point of presence in a new market by co-locating in facilities owned by other suppliers, in order to gauge market demand, prior to making a decision to open up our own co-location 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.

ANNUAL INFORMATION

Readers of this MD&A should note that the audited financial statements report 12 month results for 2004 and ten months for 2003. This is because the company, following the completion of a reverse take over in 2002, changed its year end from August 31 to June 30. To facilitate meaningful comparisons of operations, all results for 2002 and 2003 have been restated, as shown below, based on 12 months ending June 30th.

Peer 1 Network Enterprises, Inc.			
Consolidated Income Statement			
For the year ended June 30			
	2004	2003	2002
	(audited)	(unaudited)	(unaudited)
Revenue	13,587,914	9,934,024	5,212,482
Cost of sales	8,622,363	7,727,542	5,161,617
Gross profit	<u>4,965,551</u>	<u>2,206,482</u>	<u>50,865</u>
Operating Expenses	5,003,234	5,098,682	3,819,776
Operating Loss	37,683	2,892,200	3,768,911
Gain on payable settlement	-	(479,359)	-
Interest expense on payables settlement	-	479,359	-
Interest expense	952,823	396,963	167,766
Foreign exchange loss (gain)	<u>1,844</u>	<u>(67,226)</u>	<u>9,291</u>
Net loss before taxes	992,350	3,221,937	3,945,968
Provision of income taxes	-	59,398	89,565
Net loss	<u>992,350</u>	<u>3,281,335</u>	<u>4,035,533</u>
Deficit - beginning of period	<u>8,140,527</u>	<u>4,859,192</u>	<u>823,659</u>
Deficit - end of period	<u>9,132,877</u>	<u>8,140,527</u>	<u>4,859,192</u>

Overall Performance

Selected Measures of Financial Position	2004	2003	2002
Cash (including restricted cash)	\$976,848	\$650,907	\$48,068
Total Assets	9,517,460	6,494,277	4,853,243
Working Capital	-1,309,401	-1,562,265	-1,922,883
Long Term Financial Liabilities	3,319,312	3,235,074	1,194,413
Share Capital	9,914,432	6,779,922	4,927,407
Shareholders' Equity	1,437,548	-511,783	-135,844

The company made significant strides in improving its financial position during 2004. This is evident in each of the measures of financial condition shown in the table above. A restructuring of the debt instruments issued by the company that took place in July, shortly after the last fiscal year end, was a key contributor to the improved financial position. Additional cash was contributed by way of a new debt instrument issued during the year, as well as from additional draws on a line of credit agreement that was set up in an earlier phase of the debt restructuring process. In addition, contributions to share capital were made during 2004, by way of the conversion of part of a debt instrument, and from the exercise of warrants issued as part of the debt restructuring.

Details of the changes made as part of the debt restructuring agreements are set out in Note 7 to the audited annual financial statement.

Share capital has more than doubled in the last two years, with the result that Peer 1 is able to report shareholders' equity instead of shareholders' deficits for the first time in 2004. Together with the increase in long term debt, equity contributions to the company have helped fund the company's expansion into the USA over the last two years. This expansion, in combination with growth in the Canadian sites, has necessitated an investment in property and equipment with the result that the company's investment in assets has also more than doubled in the last two years.

As the company continues to operate in a growth phase with a focus on expanding operations in existing locations, adding new locations and acquiring other operating entities, the demand for additional cash resources will grow. It is expected that equity contributions and debt instruments will continue to be a major source of new cash.

Selected Measures of Operations	2004	2003	2002
Total Revenue	\$13,587,914	\$9,934,024	\$4,721,542
Gross Margin	36.5%	22.3%	1.0%
Net Loss	992,350	3,221,937	4,035,533

Revenues have increased steadily over the last two years (\$5.2 million increase in 2003, \$3.6 million in 2004) as the new co-location facilities that have been added in the last two years become more established in their local markets. Growth has been especially strong in the Canadian locations where capacity has been efficiently utilized, and which have been open longer than the three locations in the USA.

The increase in revenue has seen a commensurate increase in gross margins, given the nature of the co-location and bandwidth business, where monthly recurring costs do not vary much with increased sales due to relatively high fixed cost composition. Likewise,

there has been a significant improvement in the bottom line, since Peer 1's strategy of keeping costs low has resulted in other operating costs increasing at a rate slower than the increase in revenues.

SELECTED ANNUAL INFORMATION

	2004	2003	2002
Total Revenues	\$13,587,914	\$9,934,024	\$4,721,542
Net Loss - total	992,350	3,221,937	4,035,533
Net Loss – per share	0.02	0.09	0.11
Net Loss – diluted per share	0.02	0.09	0.11
Total Assets	9,517,460	6,494,277	4,853,243
Long Term Financial Liabilities	3,319,312	3,235,074	1,194,413
Cash Dividends Declared	Nil	Nil	Nil

RESULTS OF OPERATIONS

Revenues

Revenues in 2004 were 37% higher than for the same 12 month period in 2003. This growth was evident in both of the company's major revenue sources – bandwidth revenue which increased from \$7.2 million to \$8.3 million (15% growth) and co-location revenue which increased from \$2.4 million to \$ 4.5 million (87% growth).

The increase in co-location revenues is attributable in growth in the customer base - the number of co-location customers grew from 474 in 2003 to 656 by the end of the period, which translated into a 56% increase in the number of units sold each month. The average selling price per customer and per unit remained essentially the same from 2003 to 2004. Additional space was made available in Vancouver and Toronto during the year. Both new facilities were designated "carrier neutral", which allowed the company to expand its target market to include companies who acquired their co-location services separately from their bandwidth requirements.

Like co-location, bandwidth revenues have increased as a result of higher sales volumes. Customer traffic over the network has increased 125%, but this has been offset by falling bandwidth prices resulting from a highly competitive market – prices at the end of 2004 are 45% of their 2003 level. Bandwidth now accounts for 61% of total revenues, compared to 72% at the end of 2003.

88% of revenues earned during the year were from the company's three Canadian sites, compared to 95% in 2003. Sales at the US locations continue to grow, with some significant sized contracts added during the latter part of the year. The US locations are expected to continue their sales growth, as Peer 1 brand recognition increases.

Despite the increase in the number of customers, there is still capacity available for further growth in most co-location cities. Additional space is being added in New York and Toronto, which will provide further capacity for anticipated growth. Prior to year end, Peer 1 added points of presence in Los Angeles and London – while these are not expected to generate significant sales volumes, they expose Peer 1 to new markets at minimal cost.

Gross Profit

The gross profit for the year ended June 30 2004 was almost double that for the same 12 month period in 2003. From a profit margin of 22% in 2003, the company has been able to achieve a margin of 37% in 2004. The improvement is due primarily to the high proportion of fixed costs inherent in the co-location business – therefore every dollar of incremental revenue earned significantly improves the gross profit margin. Bandwidth margins fell during the year as a result of lower bandwidth sales prices. The company has been able to negotiate lower prices from our suppliers, which has mitigated the impact on gross margins to some extent.

Operating Expenses

The largest component of operating expenses is salaries and wages which comprise approximately 52% of the total (46% in 2002). 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, largely unchanged from 21% in 2003. No major changes are anticipated for the costs in this category.

Travel costs are 12% of total operating expenses, up from 10% in 2003. While travel costs are not directly related to sales levels, they do increase with the number of locations that Peer 1 operates at. 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 10% of total costs in 2004, unchanged from 2003. No major changes are anticipated for the costs in this category.

Projects In Start-Up Phase

In the latter part of the year, the company entered into an incorporated joint venture to provide VoIP (voice services over the Internet) services under the name Symmetric Broadband Inc. The voice traffic would be routed over the Peer 1 network, and would be complementary to the products we provide. Symmetric was still in the start-up phase at year end. At the date of this MD&A, the joint venture had signed up several customers and was generating revenues.

As is the case with Peer 1, Symmetric will focus its sales effort in locations where they currently have the required equipment, namely Los Angeles, Vancouver and New York before any consideration of expansion. Peer 1 is not expected to have to contribute a significant amount of additional funding to the joint venture as the business will grow to be self-sustaining.

SUMMARY OF QUARTERLY RESULTS

	Quarter Ended							
	September 30 2002	December 31 2002	March 31 2003	June 30 2003	September 30 2003	December 31 2003	March 31 2004	June 30 2004
Revenue	2,016,161	2,431,152	2,463,147	3,023,564	3,113,210	3,407,164	3,400,250	3,667,290
Operating Profit (Loss)	(1,074,255)	(583,806)	(781,605)	(452,534)	(196,463)	66,585	156,654	(64,459)
Net Income (Loss)	(1,150,215)	(692,512)	(773,907)	(664,701)	(504,767)	(248,638)	5,969	(244,914)
Pro forma basic and fully diluted income (loss) per share	(0.04)	(0.02)	(0.02)	(0.02)	(0.01)	(0.01)	0.00	(0.01)
EBITDA	(969,965)	(377,163)	(556,320)	(206,386)	44,078	277,177	421,865	124,530

LIQUIDITY AND CAPITAL RESOURCES

As of June 30, 2004 the company had a cash and cash equivalents balance of \$855,478 which was an increase of \$650,558 from the June 30, 2003 balance of \$204,920. The company also held restricted cash in the amount of \$121,370 in 2004 (\$445,987 in 2003). Restricted cash refers to funds received under the line of credit agreement with Polygon Financial Inc. since these are to be spent only on purposes specified in the agreement – expanding the operations of and providing working capital for Peer 1's facilities in Seattle.

The company had a working capital deficit in both 2004 (\$1.3 million) and 2003 (\$1.6 million). 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 company has a small working capital balance at year end.

Operating Activities

Operating activities used \$1.3 million less in cash in 2004 than in 2003 primarily because the increase in revenues during the year was greater than the commensurate increase in expenses. Future revenue growth is also expected to follow this trend, with the result that cash flows are anticipated to be generated from operations in the coming year.

Investing Activities

The company continues to make a significant investment in property and equipment (\$2.6 million in 2004 compared to \$1.4 million in 2003). The current level of investment is expected to continue for the next several years as the company's growth strategy takes hold.

Financing Activities

The major funding sources for the company are the issuance of capital stock (\$2.0 million in 2004; \$1.9 million in 2003), long term debt (\$1.3 million in 2004; \$2.0 million in 2003) and short term shareholder notes (\$0.7 million in 2004; \$0.5 million in 2003). The company expects that the issuance of share capital and long term debt will continue to

be the principal sources of funding. No further short term shareholder notes are expected to be required.

During the year the company repaid the remainder of its obligations under capital leases. The funds used for this purpose should therefore be available for other uses in future years.

OFF-BALANCE SHEET ARRANGEMENTS

The company has not entered into any off-balance sheet arrangements.

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. Note 11 to the annual financial statements provides additional information.

Subsequent to year end, \$70,000 in accounts receivable from a related party was written off. This amounted to half of the balance receivable from that party.

FOURTH QUARTER

Revenues continued to grow during the fourth quarter, but were offset by higher operating costs. Costs for electricity and air conditioning in the co-location facilities were higher than in the previous quarter as a result of the increase in customers. Sales salaries were also higher than in the previous quarter, as a number of additional staff were hired. The quarterly results also reflect higher professional fees, as the costs of a tax planning project are included in this quarter.

Non-operating expenses were also higher than in the previous quarter, with year end adjustments for unrealized foreign exchange losses accounting for the majority of the change.

PROPOSED TRANSACTIONS

At the date of this MD&A, the Board of Directors has reviewed preliminary proposals, but has not yet approved any proposed acquisition or disposition of assets or businesses.

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.

In 2004, 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 during the year. 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 year, \$163,000 of costs had been deferred. No change to the status of those projects has occurred during the subsequent period.

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 to the 15-20% range because of the larger base. Current results have been impacted by rapidly declining Internet bandwidth pricing. It is expected that prices will stabilize during 2005, as a result of increased demand. Management has targeted \$16 million in revenues for 2005.

As there is a high percentage of fixed co-location and bandwidth costs, the increased revenue is expected to result in improved gross profit margins. This, together with Peer 1's strict operating cost control regime, is expected to result in net income in the third and fourth quarters of fiscal 2005.

The company is aggressively pursuing a growth strategy that includes the acquisition entities whose operations would be accretive to Peer 1. While the prospects for completion of these projects cannot be determined with certainty, management has set a goal of completing at least one acquisition in 2005. Any growth in revenues and profits would be in addition to those identified above.

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 exchange fluctuations. At this time, costs denominated in US dollars exceed US denominated revenues. The anticipated revenue growth in Peer 1's US locations will offset the exchange rate 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.