



NETWORK | CO-LOCATION | DEDICATED HOSTING

Management's Discussion & Analysis  
for the Three and Six Months Ended December 31, 2006



**MANAGEMENT'S DISCUSSION AND ANALYSIS  
OF INTERIM FINANCIAL RESULTS  
FOR THE THREE AND SIX MONTHS ENDED DECEMBER 31, 2006**

*This Management Discussion and Analysis ("MD&A"), dated February 20, 2007, should be read in conjunction with Peer 1's unaudited first quarter financial statements, as well as the audited annual financial statements for the fiscal year ended June 30, 2006 and the notes thereto, all of which can be found on [www.sedar.com](http://www.sedar.com). Unless otherwise noted, all figures noted are in United States dollars.*

**FORWARD LOOKING STATEMENTS**

This 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**

**Quarterly Financial Highlights**

- Peer 1's revenue increased 11% to \$18.13 million for the three months ended December 31, 2006, compared to \$16.29 million for three month period ended December 31, 2005.
- Gross profit was \$6.75 million for the three months ended December 31, 2006, an increase of \$.87 million from \$5.88 million for the three months ended December 31, 2005.
- Operating income was \$2.28 million for the three months ended December 31, 2006 an increase of \$1.21 million from the operating profit of \$1.07 million for the three months ended December 31, 2005
- Net profit was \$0.85 million for the quarter ended December 31, 2006, compared to a net loss of \$.48 million for the quarter ended December 31, 2005.
- **Quarterly Key Developments**
- On December 21, 2006 the Company announced the election of Mark Benham, Michael Cytrynbaum, David Harrison, Werner K. Paulus, Scott Shaw, Chris Theodoropoulos, Lance Tracey and Donald F. Detampel, Jr. as directors of the company for the coming year. Mr. Detampel is a new addition to Peer 1's board this year with over 30 years experience with major corporations at senior executive and board of director levels.

- On December 21, 2006, the Company announced that Peer 1's disinterested shareholders approved implementation by the board of directors of a new incentive stock option plan which reserves for issuance 15,468,382 common shares of Peer 1 representing 20% of the outstanding common shares of the company. All outstanding options granted pursuant to Peer 1's previous option plan are now governed by the new plan and the previous plan has been terminated.

## **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. Customers include hosting providers, online gaming companies, Internet phone (VoIP) companies and small and medium-sized businesses across North America. Peer 1 has established data centers 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.

Management of Peer 1 believes that the Company has been successful in attracting and generating business as a result of:

- Access to a high bandwidth, high quality IP network
- 24 hours, 7 days a week monitoring
- Environmentally protected facilities
- High level of physical security
- Customer support

### **Dedicated Hosting**

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 solution where a client leases a Peer 1 server 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 the same, but the customer performs all 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 rental 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 and the UK. 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 servers built with quality parts within a low cost infrastructure that supports a price competitive strategy. 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 networks, 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 secondly, 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.

## **RESULTS OF OPERATIONS**

The table below presents, for the periods indicated, the statement of operations.

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

	Three Months Ended December 2006 US\$	Three Months Ended December 2005 US\$	Six Months Ended December 2006 US\$	Six Months Ended December 2005 US\$
Revenue	18,131,221	16,286,700	35,617,388	25,964,979
Cost of Sales	11,378,049	10,402,326	22,644,255	16,362,182
Gross Profit	6,753,172	5,884,374	12,973,133	9,602,797
Operating expenses	4,469,629	4,810,086	8,917,411	7,433,200
Operating Income before other items	2,283,543	1,074,288	4,055,722	2,169,597
Other Items:				
Amortization of preferred share discount	374,215	260,565	731,354	404,792
Interest expense - long term	835,663	1,041,378	1,661,489	2,033,875
Interest expense - short term	-	-	-	34,854
Interest accretion on notes payable	54,776	63,836	110,431	541,460
Integration costs	292,980	365,125	517,542	432,688
Foreign exchange loss (gain)	(4,882)	(174,993)	(37,769)	208,476
Loss on disposal of fixed assets	50,816	-	46,131	-
Loss from equity accounted investment	-	-	-	13,114
Income (Loss) before income taxes	679,975	(481,623)	1,026,544	(1,499,662)
Future income tax recovery	(624,919)	-	(624,919)	-
Current Income tax expense	456,043	-	553,161	-
Income tax recovery	(168,876)	-	(71,758)	-
Income (Loss) for the period	848,851	(481,623)	1,098,302	(1,499,662)
Deficit, beginning of period	(11,458,278)	(9,538,288)	(11,707,729)	(8,520,249)
Deficit, end of period	(10,609,427)	(10,019,911)	(10,609,427)	(10,019,911)
Basic earnings (loss) per share	0.01	(0.01)	0.01	(0.02)
Diluted earnings (loss) per share	0.01	(0.01)	0.01	(0.02)

## Acquisitions

Over the past three years, Peer 1's strategic focus has expanded through the execution of our 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. The shift in sources of revenue is attributable to the FY2005 acquisition of ServerBeach Ltd. and the 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, totaling over 115,000 square feet and 8,300 servers. Interland has since been renamed Web.com.

For the quarter ended December 31, 2006 dedicated server revenue accounted for 72% of total revenue, compared to 73% for the quarter ended December 31, 2005.

## Revenues

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

Set-up fees are charges customers pay for initial configuration and installation of services. These services are typically billed once and only upon completion of such configuration and installation.

	Three months ended December 31				Six Months ended December 31			
	2006	%	2005	%	2006	%	2005	%
Revenue:								
Colocation	2,421,727	13%	1,926,187	12%	4,707,953	13%	3,672,965	14%
Bandwidth	1,982,867	11%	2,053,970	13%	4,162,595	12%	3,996,045	15%
Services (Set up fees)	697,461	4%	469,995	3%	1,228,940	3%	881,502	3%
Dedicated Servers	13,029,166	72%	11,836,548	73%	25,517,900	72%	17,414,467	67%
<b>Total Revenue</b>	<b>18,131,221</b>	<b>100%</b>	<b>16,286,700</b>	<b>100%</b>	<b>35,617,388</b>	<b>100%</b>	<b>25,964,979</b>	<b>100%</b>

Consolidated revenue increased to \$18.13 million for the three months ended December 31, 2006 from \$16.29 million for the three months ended December 31, 2005. The increase in revenue for the quarter is attributable to organic growth. Consolidated revenue increased to \$35.62 million for the six months ended December 31, 2006 from \$25.96 million for the six months ended December 31, 2005. The increase in revenue is primarily attributable to six months of revenue from Dedicated Hosting during the six month period ended December 31, 2006 compared to four months of revenue from Dedicated Hosting during the same period last fiscal year, as well as to organic growth.

Co-location revenues increased to \$2.42 million in the three months ended December 31, 2006 from \$1.93 million for the three months ended December 31, 2005. Co-location revenues increased to \$4.7 million for the six months ended December 31, 2006 from \$3.67 million for the six months ended December 31, 2005. The increase is attributable to improved pricing and increased sales volume.

Bandwidth revenues were largely unchanged at \$1.98 million in the three months ended December 31, 2006 compared to \$2.05 million in the three months ended December 31, 2005. Bandwidth revenues increased to \$4.16 million for the six months ended December 31, 2006 from \$3.99 million for the six months ended December 31, 2005.

Dedicated server revenues increased to \$13.03 million for the three months ended December 31, 2006 from \$11.84 million for the three months ended December 31, 2005. Dedicated server revenues increased to \$25.52 million in the six months ended December 31, 2006 from \$17.41 million for the six months ended December 31, 2005. The increase for the three and six month period ended December 31, 2006 is attributable to increased sales, addition of new customers, an overall decrease in customer churn rates and six months of revenue from Dedicated Hosting for the six month period ended December 31, 2006, compared to four months of revenue from Dedicated Hosting during the same period last fiscal year.

The Company's Canadian operations accounted for \$3.83 million of revenues in the three month period ended December 31, 2006 compared to \$3.47 million of revenues in the three months ended December 31, 2005. The Company's Canadian operations accounted for \$7.55 million of revenues in the six month period ended December 31, 2006 compared to \$6.55 of revenues in the six months ended December 31, 2005. This change is the result of increased co-location revenues in the Canadian operations for the current quarter compared to the same period last year.

## Cost of Sales

Cost of sales for the Company are 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, and supplies. Variable costs consist of power consumption, and incremental bandwidth from upstream carriers.

Consolidated cost of sales increased to \$11.38 million for the three months ended December 31, 2006 from \$10.40 million for the three months ended December 31, 2005. Cost of sales as a percentage of revenue decreased to 63% in the quarter ended December 31, 2006 from 64% for the period ended December 31, 2005. Consolidated cost of sales increased to \$22.64 million for the six months ended December 31, 2006 from \$16.36 million for the six months ended December 31, 2005. Cost of sales as a percentage of revenue increased to 64% in the six months ended December 31, 2006 from 63% for the six months ended December 31, 2005. The cost of sales increase for the six month period ended December 31, 2006 is 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.

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 cost of facilities, servers and bandwidth.

## Operating Expenses

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

	Three months ended December 31				Six Months ended December 31			
	2006	%	2005	%	2006	%	2005	%
Total Operating Expenses	4,469,629	25%	4,810,086	30%	8,917,411	25%	7,433,200	29%

Total operating expenses decreased to \$4.47 million for the three months ended December 31, 2006 from \$4.81 million for the three months ended December 31, 2005, as a result of efficiencies attributable to the integration of the Dedicated Hosting assets. Operating expenses as a percentage of revenue decreased to 24.6% in the quarter ended December 31, 2006 from 29.5% for the quarter ended December 31, 2005. Total operating expenses increased to \$8.92 million for the six months ended December 31, 2006 from \$7.43 million for the six months ended December 31, 2005. Operating expenses as a percentage of revenue decreased to 25% in the six months ended December 31, 2006 from 28.6% for the six months ended December 31, 2005. The significant increase in operating expenses for the six month period ended December 31, 2006 compared to the same period

in the prior fiscal year is a result of six months of operating expenses from Dedicated Hosting for the six month period ended December 31, 2006, compared to four months of operating expenses from Dedicated Hosting during the same period last fiscal year.

The largest component of operating expenses is general and administrative which accounted for 64% for the three and six months ended December 31, 2006 compared to 71% and 69% for the three and six months ended December 31, 2005 respectively. 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 27% for the three and six months ended December 31, 2006 compared to 22% and 24% for the three and six months ended December 31, 2005 respectively.

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 \$0.37 million in integration costs in the quarter ended December 31, 2006, of which \$0.29 million was expensed, \$0.08 million was capitalized as internally developed software and \$Nil million was capitalized as computer equipment. For the six month period ended December 31, 2006 the Company incurred \$1.06 million in integration costs, of which \$0.52 million was expensed, \$0.49 million was capitalized as internally developed software and \$0.06 million was capitalized as computer equipment. The Company anticipates expenses for these activities to continue through the balance of this fiscal year. Integration costs include the cost of a new billing, ticketing and customer support system in addition to separation of business operations.

## SUMMARY OF QUARTERLY RESULTS

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

	Quarter Ended (in thousands \$)							
	March 31	June 30	30-Sep	31-Dec	March 31	June 30	30-Sep	31-Dec
	2005	2005	2005	2005	2006	2006	2006	2006
	(US\$)	(US\$)	(US\$)	(US\$)	(US\$)	(US\$)	(US\$)	(US\$)
Revenue	5,843	6,019	9,678	16,287	17,627	17,134	17,486	18,131
Operating Profit (Loss)	(12)	500	1,095	1,074	1,224	638	1,772	2,284
Net Income (Loss)	(762)	(654)	(1,018)	(481)	(355)	(1,333)	249	849
Basic income (loss) per share	(0.02)	(0.02)	(0.02)	(0.01)	(0.01)	(0.01)	0.00	0.01
Fully diluted income (loss) per share	(0.02)	(0.02)	(0.02)	(0.01)	(0.01)	(0.01)	0.00	0.01

### Liquidity and Capital Resources

Peer 1 has historically financed its operations through cash generated from operations, sale of common and preferred shares and issuance of debt. As at December 31, 2006, the Company had cash and cash equivalents of \$5.34 million (including \$.5 million in restricted cash – see Off-Balance Sheet Arrangements section), compared to \$6.17 million (including \$.5 million in restricted cash) as

at June 30, 2006. The Company had long term debt (in the form of Preferred Shares Series A, please refer to the Company's 2006 annual report for more information) of \$8.82 million and notes payable of \$19.42 million as at December 31, 2006 compared to \$8.1 million long term debt and notes (including shareholder notes) payable of \$21 million as at June 30, 2006.

The Company had a working capital deficit of \$4.2 million at December 31, 2006 compared to a working capital deficit of \$4.2 million as the end of September 30, 2006.

The working capital deficit of \$4.2 million at December 31, 2006 includes deferred revenue of \$3.99 million and current portion of notes payable of \$3.66 million. The Company anticipates current liquidity and cash generated from operations to be sufficient to fund existing operations for the foreseeable future.

### **Operating Activities**

Cash flow from operating activities for the three months ended December 31, 2006 and 2005 was \$3.55 million and \$4.54 million, respectively. Cash flow from operating activities for the six months ended December 31, 2006 and 2005 was \$4.88 million and \$7.42 million, respectively. The decrease in cash provided by operations for the three and six months ended December 31, 2006 resulted primarily from decreased cash flow from working capital items as a result of payment of accounts payable and other accrued liabilities. Excluding changes in non-cash working capital items, Cash flow from operating activities for the three months ended December 31, 2006 and 2005 was \$3.87 million and \$3.98 million, respectively. Cash flow from operating activities for the six months ended December 31, 2006 and 2005 was \$8.3 million and \$6.78 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 three months ended December 31, 2006 and 2005 was \$3.29 million and \$2.39 million, respectively. Cash used by investing activities for the six months ended December 31, 2006 and 2005 was \$5.81 million and \$22.27 million, respectively. The increase in use of cash for the three month period ended December 31, 2006 compared to the same period last year is a result of capital expenditures to fund the Company's operations and growth strategy, which includes purchases of cabinets/cages and computer equipment, such as servers, routers and firewalls. The decrease in use of cash for the six month period ended December 31, 2006 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**

Cash outflows from financing activities for the three months ended December 31, 2006 was \$.79 million compared to \$1.86 million for the three months ended December 31, 2005. Cash provided by financing activities for the six months ended December 31, 2006 and 2005 was \$.1 million and \$20.54 million, respectively. The decrease in cash from financing activities for the six months ended December 31, 2006 compared to the same period ended December 31, 2005 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, as discussed in the Company's first and second quarter fiscal 2006 financial statements and MD&A.

### **OFF-BALANCE SHEET ARRANGEMENTS**

As of December 31, 2006 the Company has provided two letters of credit totaling US\$.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**

The company has entered into a number of related party transactions with companies either owned or subject to significant influence by the company's management, directors and principal shareholders.

At December 31, 2006 amounts due to and from related parties were as follows:

	<b>FY2007</b>	<b>FY2006</b>
Accounts receivable from related companies	\$7,934	\$91,208
Accounts payable to related party	\$9,248	\$525

During the six month period ending December 31, 2006 transactions with related parties were as follows:

	<b>FY2007</b>	<b>FY2006</b>
Revenues earned	\$60,188	\$56,563
Interest expensed	-	\$334,286
Other expenses incurred	\$264,608	\$8,902

These transactions are in the normal course of operations and are measured at their exchange amounts. Other expenses incurred include management and consulting fees of \$250,041.

Details of related party transactions for the three months ended December 31, 2006

Related person or entity	Related person	A/R	A/P	USD		
				Revenue	Interest	Other
Celerity Partners	Mark Benham	-	-	-	-	800 Expense chargeback \$800
Code Marketing Ltd.	Lance Tracey	-	-	-	-	123,333 Management fees \$123,333
E-Xact Transactions Ltd.	Scott Shaw, Lance Tracey	5,466	153	16,796	-	430 1) Revenue from contract to provide colocation and bandwidth in Vancouver \$16,796...2) E-Xact provides Peer 1 with credit card gateway processing services \$430
Fatport	Michael Cytrynbaum	1,508	-	2,298	-	- Revenue from contract to provide colocation and bandwidth in Vancouver.
Pubsub Concepts Inc.	Lance Tracey	960	-	1,000	-	11,869 Revenue from contract to provide colocation and bandwidth in New York. Other expenses due to written off account receivable.
Sutton Group Realty Services Ltd.	Scott Shaw, Lance Tracey	-	9,096	-	-	26,329 Consulting expenses CDN\$10000 per month
		7,934	9,248	20,094	-	162,761

## SUBSEQUENT EVENTS AND PROPOSED TRANSACTIONS

- On February 1, 2007 the Company announced that its previously announced data center expansion in Vancouver is complete, increasing the Company's co-location capacity by over 140 cabinet equivalents. Additionally the Company announced an expansion of its Toronto Data center that will accommodate a further 125 cabinets, with completion scheduled before the end of June 2007.
- 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 enables 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.

## OUTSTANDING SHARE DATA

Peer 1 has authorized share capital of unlimited common shares without par value and unlimited preferred shares without par value. At December 31, 2006 77,541,913 common shares were issued and outstanding. As of the date of this MD&A 79,388,163 common shares were issued and outstanding.

At December 31, 2006 6,239,904 warrants for the purchase of shares ranging in price from US\$0.23 to CAD\$0.40 (approximately US\$0.3432) were outstanding. As the date of this MD&A nil warrants have been issued or exercised subsequent to the end of the quarter.

As at December 31, 2006 8,556,850 stock options were outstanding under the Company's stock option plan. Subsequent to the quarter ended December 31, 2006 and as of the date of this MD&A, 1,846,250 options were exercised and 100,000 additional options have been granted. Stock options outstanding as of the date of this MD&A are 6,810,600.

In accordance with the Investor Rights Agreement, the holders of the 7,000 preferred shares Series A may require the Company to acquire any or all of their preferred shares in exchange for common shares of Peer 1. Subject to adjustment in specified circumstances, the conversion would be for 4,365 common shares of Peer 1 for each preferred share having a face value of \$1,000. If all of the 7,000 Preferred shares were converted inclusive of cumulative but unpaid dividends, as of the date of this MD&A 34,236,120 Common shares of the Company would be issued in satisfaction of the conversion right.

If all preferred shares were converted and all warrants and options were exercised there would be a total of 126,674,787 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 2-2.5% 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).

The Company recognized future income tax assets in the amount of \$0.62 million for the three and six months ended December 31, 2006 related to accumulated non-capital tax losses and temporary differences. Management believes there is sufficient uncertainty regarding the realization of additional future tax assets relating to non-capital losses in the amount of approximately \$3.1 million and temporary differences between accounting income and income for tax purposes of \$5.9 million such that a valuation allowance has been provided. Management evaluates the taxable position of the Company quarterly and considers factors including estimated taxable income, the history of losses for tax purposes, and growth of the Company.

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 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 to 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 and execution of strategic relationships, 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 the company is available on SEDAR at [www.sedar.com](http://www.sedar.com).