

NAVISITE INC  
Form 10-Q  
December 17, 2008

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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549  
FORM 10-Q**

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934**

**For the quarterly period ended October 31, 2008**

**OR**

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934**

**For the transition period from \_\_\_\_\_ to \_\_\_\_\_**

**Commission file number: 000-27597**

**NAVISITE, INC.**

(Exact name of registrant as specified in its charter)

**Delaware**

(State or other jurisdiction of  
incorporation or organization)

**52-2137343**

(I.R.S. Employer  
Identification No.)

**400 Minuteman Road**

**Andover, Massachusetts**

(Address of principal executive offices)

**01810**

(Zip Code)

**(978) 682-8300**

(Registrant's telephone number, including area code)

**None**

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller Reporting Company   
(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

As of December 9, 2008, there were 35,395,038 shares outstanding of the registrant's common stock, par value \$.01 per share.

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REPORT ON FORM 10-Q  
FOR THE QUARTER ENDED OCTOBER 31, 2008**

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**NAVISITE, INC.**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**  
**(Unaudited)**  
**(In thousands, except par value)**

|   | <b>October 31,<br/>2008</b> | <b>July 31,<br/>2008</b> |
|---|-----------------------------|--------------------------|
| <b>ASSETS</b>   |                             |                          |
| Current assets:   |                             |                          |
| Cash and cash equivalents   | \$ 5,020                    | \$ 3,261                 |
| Accounts receivable, less allowance for doubtful accounts of \$999 and \$897 at October 31, 2008 and July 31, 2008, respectively                              | 20,777                      | 18,927                   |
| Unbilled accounts receivable  | 1,596                       | 1,711                    |
| Prepaid expenses and other current assets   | 7,923                       | 11,557                   |
| Total current assets  | 35,316                      | 35,456                   |
| Property and equipment, net   | 36,471                      | 38,141                   |
| Intangible assets   | 27,452                      | 29,290                   |
| Goodwill  | 66,566                      | 66,683                   |
| Other assets  | 5,227                       | 4,258                    |
| Restricted cash   | 1,760                       | 1,885                    |
| Total assets  | \$ 172,792                  | \$ 175,713               |
| <b>LIABILITIES AND STOCKHOLDERS DEFICIT</b>   |                             |                          |
| Current liabilities:  |                             |                          |
| Notes payable, current portion  | \$ 4,792                    | \$ 6,100                 |
| Capital lease obligations, current portion  | 3,271                       | 3,166                    |
| Accounts payable  | 8,343                       | 7,033                    |
| Accrued expenses and other current liabilities  | 13,554                      | 13,336                   |
| Deferred revenue, deferred other income and customer deposits   | 6,167                       | 4,163                    |
| Total current liabilities   | 36,127                      | 33,798                   |
| Capital lease obligations, less current portion   | 12,515                      | 14,922                   |
| Accrued lease abandonment costs, less current portion   | 334                         | 428                      |
| Deferred tax liability  | 6,096                       | 5,597                    |
| Other long-term liabilities   | 3,873                       | 4,361                    |
| Note payable, less current portion  | 107,575                     | 107,850                  |
| Total liabilities   | 166,520                     | 166,956                  |
| Series A Convertible Preferred Stock, \$0.01 par value; Authorized 5,000 shares; Issued and outstanding: 3,386 at October 31, 2008 and 3,320 at July 31, 2008 | 28,331                      | 27,529                   |

Commitments and contingencies (Note 11)

Stockholders' deficit:

|   |                |                |
|---|----------------|----------------|
| Common stock, \$0.01 par value; Authorized 395,000 shares; Issued and outstanding: 35,390 at October 31, 2008 and 35,232 at July 31, 2008 | 354            | 352            |
| Accumulated other comprehensive income (loss)   | (831)          | 253            |
| Additional paid-in capital  | 485,428        | 485,086        |
| Accumulated deficit   | (507,010)      | (504,463)      |
| <br>Total stockholders' deficit   | <br>(22,059)   | <br>(18,772)   |
| <br>Total liabilities and stockholders' deficit   | <br>\$ 172,792 | <br>\$ 175,713 |

See accompanying notes to condensed consolidated financial statements.

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**NAVISITE, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**  
**(Unaudited)**  
**(In thousands, except per share amounts)**

|   | <b>Three Months Ended</b>   |                            |
|---|-----------------------------|----------------------------|
|   | <b>October 31,<br/>2008</b> | <b>October 31<br/>2007</b> |
| Revenue, net  | \$39,778                    | \$36,032                   |
| Revenue, related parties  | 83                          | 75                         |
| Total revenue, net  | 39,861                      | 36,107                     |
| Cost of revenue, excluding restructuring charge, depreciation and amortization  | 21,731                      | 20,858                     |
| Depreciation and amortization   | 5,703                       | 4,187                      |
| Restructuring charge  | 214                         |                            |
| Cost of revenue   | 27,648                      | 25,045                     |
| Gross profit  | 12,213                      | 11,062                     |
| Operating expenses:   |                             |                            |
| Selling and marketing   | 5,440                       | 5,164                      |
| General and administrative  | 5,963                       | 5,622                      |
| Restructuring charge  | 262                         |                            |
| Total operating expenses  | 11,665                      | 10,786                     |
| Income from operations  | 548                         | 276                        |
| Other income (expense):   |                             |                            |
| Interest income   | 4                           | 114                        |
| Interest expense  | (3,044)                     | (2,657)                    |
| Loss on debt extinguishment   |                             | (1,651)                    |
| Other income (expense), net   | 461                         | 275                        |
| Loss from continuing operations before income taxes and discontinued operations | (2,031)                     | (3,643)                    |
| Income taxes  | (499)                       | (413)                      |
| Loss from continuing operations before discontinued operations                  | (2,530)                     | (4,056)                    |
| Loss from discontinued operations, net of income taxes                          | (17)                        | (314)                      |
| Net loss  | (2,547)                     | (4,370)                    |

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|  |            |            |
|--|------------|------------|
| Accretion of preferred stock dividends   | (802)      | (384)      |
| Net loss attributable to common stockholders   | \$ (3,349) | \$ (4,754) |
| Basic and diluted net loss per common share:   |            |            |
| Loss from continuing operations before discontinued operations attributable to common stockholders | \$ (0.09)  | \$ (0.13)  |
| Loss from discontinued operations, net of income taxes   |            | (0.01)     |
| Net loss attributable to common stockholders   | \$ (0.09)  | \$ (0.14)  |
| Basic and diluted weighted average number of common shares outstanding                             | 35,344     | 33,917     |
| Stock-based compensation expense:  |            |            |
| Cost of revenue  | \$ 379     | \$ 556     |
| Selling and marketing  | 182        | 252        |
| General and administrative   | 408        | 429        |
| Restructuring  | 51         |            |
| Total stock-based compensation expense   | \$ 1,020   | \$ 1,237   |

See accompanying notes to condensed consolidated financial statements.

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**NAVISITE, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**(Unaudited)**  
**(In thousands)**

|  | <b>Three Months Ended</b>   |                             |
|--|-----------------------------|-----------------------------|
|  | <b>October 31,<br/>2008</b> | <b>October 31,<br/>2007</b> |
| Cash flows from operating activities of continuing operations:   |                             |                             |
| Net loss   | \$(2,547)                   | \$ (4,370)                  |
| Loss from discontinued operations  | 17                          | 314                         |
| Loss from continuing operations before discontinued operations   | (2,530)                     | (4,056)                     |
| Adjustments to reconcile net loss to net cash provided by operating activities of continuing operations: |                             |                             |
| Depreciation and amortization  | 5,876                       | 4,387                       |
| Mark to market for interest rate cap   | 4                           | 70                          |
| Stock based compensation   | 1,020                       | 1,237                       |
| Provision for bad debts  | 168                         | 92                          |
| Deferred income tax expense  | 499                         | 413                         |
| Loss on debt extinguishment  |                             | 1,651                       |
| Changes in operating assets and liabilities:   |                             |                             |
| Accounts receivable  | (2,401)                     | 1,687                       |
| Unbilled accounts receivable   | (160)                       | (79)                        |
| Prepaid expenses and other current assets, net   | 3,864                       | (1,383)                     |
| Long term assets   | (106)                       | (10)                        |
| Accounts payable   | 1,421                       | (363)                       |
| Long-term liabilities  | (486)                       | (202)                       |
| Accrued expenses, deferred revenue and customer deposits   | 2,368                       | (3,359)                     |
| Net cash provided by operating activities of continuing operations                                       | 9,537                       | 85                          |
| Cash flows from investing activities of continuing operations:   |                             |                             |
| Purchase of property and equipment   | (3,736)                     | (2,853)                     |
| Cash used for acquisitions, net of cash acquired   |                             | (31,277)                    |
| Releases of (transfers to) restricted cash   | (1)                         | 8,708                       |
| Net cash used for investing activities of continuing operations  | (3,737)                     | (25,422)                    |
| Cash flows from financing activities of continuing operations:   |                             |                             |
| Proceeds from exercise of stock options and warrants   | 126                         | 1,210                       |
| Borrowings on notes payable  | 905                         | 22,801                      |
| Repayment of notes payable   | (2,488)                     | (2,465)                     |
| Debt issuance costs  | (1,184)                     | (1,072)                     |
| Payments on capital lease obligations  | (1,213)                     | (1,073)                     |
| Net cash provided by financing activities of continuing operations                                       | (3,854)                     | 19,401                      |



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|   |          |           |
|---|----------|-----------|
| Cash provided by (used for) operating activities of discontinued operations             | 12       | (286)     |
| Effect of exchange rate changes on cash and cash equivalents                            | (199)    |           |
| Net increase (decrease) in cash and cash equivalents                                    | 1,759    | (6,222)   |
| Cash and cash equivalents, beginning of period  | 3,261    | 11,701    |
| Cash and cash equivalents, end of period  | \$ 5,020 | \$ 5,479  |
| Supplemental disclosure of cash flow information:                                       |          |           |
| Cash paid for interest  | \$ 2,902 | \$ 2,415  |
| Supplemental disclosure of non-cash transactions:                                       |          |           |
| Equipment and leasehold improvements acquired under capital leases                      | \$ 1,357 | \$ 1,242  |
| Issuance of Series A Convertible Preferred Stock in connection with netASPx acquisition | \$       | \$ 24,873 |
| Accretion of Preferred Stock  | \$ 802   | \$ 384    |

See accompanying notes to condensed consolidated financial statements.

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**NAVISITE, INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**(Unaudited)**

**(1) Description of Business**

NaviSite, Inc. ( NaviSite , the Company , we , us or our ) provides application management, managed hosting solutions and professional services for mid-market organizations. Leveraging our set of technologies and subject matter expertise, we deliver cost-effective, flexible solutions that provide responsive and predictable levels of service for our customers' businesses. Over 1,400 companies across a variety of industries rely on NaviSite to build, implement and manage their mission-critical systems and applications. NaviSite is a trusted advisor committed to ensuring the long-term success of our customers' business applications and technology strategies. At October 31, 2008, NaviSite had 16 state-of-the-art data centers in the United States and United Kingdom and a network operations center in India. Substantially all revenue is generated from customers in the United States.

**(2) Summary of Significant Accounting Policies****(a) Basis of Presentation and Principles of Consolidation**

The accompanying unaudited condensed consolidated financial statements include the accounts and operations of the Company and its wholly-owned subsidiaries and have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission regarding interim financial reporting. Accordingly, they do not include all of the information and notes required by U.S. generally accepted accounting principles ( U.S. GAAP ) for complete financial statements and thus should be read in conjunction with the audited consolidated financial statements included in our Annual Report on Form 10-K filed on November 6, 2008. In the opinion of management, the accompanying unaudited condensed consolidated financial statements contain all adjustments, consisting only of those of a normal recurring nature, necessary for a fair presentation of the Company's financial position, results of operations and cash flows at the dates and for the periods indicated. The results of operations for the three months ended October 31, 2008 are not necessarily indicative of the results expected for the remainder of the fiscal year ending July 31, 2009.

All significant intercompany accounts and transactions have been eliminated in consolidation.

**(b) Use of Estimates**

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reported period. Actual results could differ from those estimates. Significant estimates made by management include the useful lives of fixed assets and intangible assets, the recoverability of long-lived assets, the collectability of receivables, the determination and valuation of goodwill and acquired intangible assets, the determination of revenue and related revenue reserves, the determination of the fair value of stock-based compensation, the determination of the deferred tax valuation allowance, the determination of certain accrued liabilities and other assumptions for sublease and lease abandonment reserves.

**(c) Revenue Recognition**

Revenue, net consists of monthly fees for application management services, managed hosting solutions, co-location and professional services. Reimbursable expenses charged to clients are included in revenue, net and cost of revenue. Application management, managed hosting solutions and co-location services are billed and recognized as revenue over the term of the contract, generally one to five years. Installation and up-front fees associated with application management, managed hosting solutions and co-location services are billed at the time the installation service is provided and recognized as revenue over the longer of the expected term or the term of the related contract. Payments received in advance of providing services are deferred until the period such services are delivered.

Revenue from professional services is recognized as services are delivered for time and materials type contracts and using the percentage of completion method for fixed price contracts. For fixed price contracts, progress towards completion is measured by a comparison of the total hours incurred on the project to date to the total estimated hours

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**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
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required upon completion of the project. When current contract estimates indicate that a loss is probable, a provision is made for the total anticipated loss in the current period. Contract losses are determined to be the amount by which the estimated service delivery costs of the contract exceed the estimated revenue that will be generated by the contract. Unbilled accounts receivable represent revenue for services performed that have not yet been billed as of the balance sheet date. Billings in excess of revenue recognized are recorded as deferred revenue until the applicable revenue recognition criteria are met.

In accordance with Emerging Issues Task Force (EITF) Issue No. 00-21, *Revenue Arrangements with Multiple Deliverables*, when more than one element such as professional services, installation and hosting services are contained in a single arrangement, the Company allocates revenue between the elements based on acceptable fair value allocation methodologies, provided that each element meets the criteria for treatment as a separate unit of accounting. An item is considered a separate unit of accounting if it has value to the customer on a stand alone basis and there is objective and reliable evidence of the fair value of the undelivered items. The fair value of the undelivered elements is determined by the price charged when the element is sold separately, or in cases when the item is not sold separately, by using other acceptable objective evidence. Management applies judgment to ensure appropriate application of EITF 00-21, including the determination of fair value for multiple deliverables, determination of whether undelivered elements are essential to the functionality of delivered elements, and timing of revenue recognition, among others. For those arrangements where the deliverables do not qualify as a separate unit of accounting, revenue from all deliverables are treated as one accounting unit and generally is recognized ratably over the term of the arrangement.

**(d) Cash and Cash Equivalents and Restricted Cash**

The Company considers all highly liquid securities with original maturities of three months or less to be cash equivalents. The Company had restricted cash of \$1.9 million as of October 31, 2008 and July 31, 2008, including \$0.1 million that was classified as short-term in the October 31, 2008 Condensed Consolidated Balance Sheet and is included in *Prepaid expenses and other current assets*. At October 31, 2008, restricted cash consists of cash collateral requirements for standby letters of credit associated with several of the Company's facility and equipment leases.

**(e) Property and Equipment**

Property and equipment are stated at cost. Depreciation is computed using the straight-line method over the estimated useful lives of the assets, which range from three to five years. Leasehold improvements and assets acquired under capital leases that transfer ownership are amortized using the straight-line method over the shorter of the lease term or the estimated useful life of the asset. Assets acquired under capital leases that do not transfer ownership or contain a bargain purchase option are amortized over the lease term. Expenditures for maintenance and repairs are charged to expense as incurred.

Renewals and betterments, which materially extend the life of assets, are capitalized and depreciated. Upon disposal, the asset cost and related accumulated depreciation are removed from their respective accounts and any gain or loss is reflected within *Other income (expense), net* in our Condensed Consolidated Statements of Operations.

**(f) Long-lived Assets, Goodwill and Other Intangibles**

The Company follows the provisions of Statement of Financial Accounting Standards ( *SFAS* ) No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. SFAS No. 144 requires that long-lived assets and certain identifiable intangibles be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to the undiscounted future net cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. Assets to be disposed

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of are reported at the lower of the carrying amount or fair value less cost to sell.

The Company reviews the valuation of goodwill in accordance with SFAS No. 142, *Goodwill and Other Intangible Assets*. Under the provisions of SFAS No. 142, goodwill is required to be tested for impairment annually in lieu of being amortized. This testing is generally done in the fourth fiscal quarter of each year. Furthermore, goodwill is required to be tested for impairment on an interim basis if an event or circumstance indicates that it is more likely than not that an impairment loss has been incurred. An impairment loss shall be recognized to the extent that the carrying amount of goodwill exceeds its fair value. Impairment losses are recognized in operations. The Company's valuation methodology for assessing impairment requires management to make judgments and assumptions based on historical experience and projections of future operating performance. If these assumptions differ materially from future results, the Company may record additional impairment charges in the future.

**(g) Concentration of Credit Risk**

Our financial instruments include cash, accounts receivable, obligations under capital leases, debt agreements, derivative instruments, preferred stock, accounts payable, and accrued expenses. As of October 31, 2008, the carrying cost of these instruments approximated their fair value. Financial instruments that may subject us to concentrations of credit risk consist primarily of accounts receivable. Concentrations of credit risk with respect to trade receivables are limited due to the large number of customers across many industries that comprise our customer base. No customer accounted for more than 5% of total revenues for the three months ended October 31, 2008 or more than 5% of total accounts receivable balance as of October 31, 2008.

**(h) Comprehensive Income (Loss)**

Comprehensive income (loss) is defined as the change in equity of a business enterprise during a period of time from transactions and other events and circumstances from non-owner sources. The Company records the components of comprehensive income (loss), primarily foreign currency translation adjustments, in the Condensed Consolidated Balance Sheets as a component of Stockholders' Deficit, Accumulated other comprehensive income (loss). For the three months ended October 31, 2008 and 2007, comprehensive income (loss) totaled approximately \$3.6 million and \$4.3 million, respectively.

**(i) Advertising Costs**

The Company charges advertising costs to expense in the period incurred. Advertising expense for the three months ended October 31, 2008 and 2007 were approximately \$100,000 and \$141,000, respectively.

**(j) Income Taxes**

We account for income taxes under the asset and liability method in accordance with SFAS No. 109, *Accounting for Income Taxes*. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

**(k) Stock Based Compensation*****Stock Options***

The Company maintains three stock incentive plans under which employees and outside directors have been granted nonqualified stock options to purchase the Company's common stock. Only one plan, the NaviSite 2003

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**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**(Unaudited)**

Stock Incentive Plan ( 2003 Plan ), is currently available for new equity award grants. For the Company's employees, options granted are generally exercisable as to 25% of the original number of shares on the sixth month anniversary of the option holder's grant date and, thereafter, in equal amounts monthly over the three year period commencing on the sixth month anniversary of the option holder's grant date. Options granted under the 2003 Plan have a maximum term of ten years.

The Company's current practice is to grant all options with an exercise price equal to the fair market value of the Company's common stock on the date of grant. During the three months ended October 31, 2008, the Company issued stock options for the purchase of approximately 0.4 million shares of common stock at a weighted average exercise price per share of \$2.08. During the three months ended October 31, 2007, the Company issued stock options for the purchase of approximately 1.1 million shares of common stock at a weighted average exercise price per share of \$7.62.

The fair value of each option issued under the 2003 Plan is estimated on the date of grant using the Black-Scholes Model, based upon the following weighted average assumptions:

|                         | <b>Three Months Ended<br/>October 31,</b> |             |
|-------------------------|---|-------------|
|                         | <b>2008</b>                               | <b>2007</b> |
| Expected life (years)   | 2.5                                       | 2.5         |
| Expected volatility     | 79.53%                                    | 85.56%      |
| Expected dividend rate  | 0.00%                                     | 0.00%       |
| Risk-free interest rate | 2.02%                                     | 4.05%       |

Stock compensation expense related to stock options recognized in the Condensed Consolidated Statements of operations is as follows:

|                            | <b>Three Months Ended<br/>October 31,<br/>(in thousands)</b> |             |
|----------------------------|--|-------------|
|                            | <b>2008</b>  | <b>2007</b> |
| Cost of revenue            | \$320  | \$ 556      |
| Selling and marketing      | 147  | 252         |
| General and administrative | 181  | 339         |
| Total                      | \$648  | \$1,147     |

There is a total of \$51,000 of stock compensation which relates to an acceleration of stock compensation expense due to a change in status pursuant to separation agreements. Of this total, \$40,000 is a general and administrative expense and \$11,000 is a cost of revenue expense.

**Non-vested Shares**

During the three months ended October 31, 2008, the Company granted approximately 0.8 million non-vested shares of common stock to certain executives under the 2003 Plan, at a weighted average grant date fair value of \$3.29 per share. The grant date fair value of the non-vested shares was determined using Monte Carlo simulations allowing for the incorporation of market based hurdles. These shares are subject to certain vesting criteria: (i) for the first third of the shares, 50% vests upon the Company exceeding a market capitalization of \$182,330,695 for 20 consecutive trading days and the remaining 50% of such one third vests on the one year anniversary thereafter, (ii)

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**NAVISITE, INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**(Unaudited)**

for the second third of the shares, 50% vests upon the company exceeding a market capitalization of \$232,330,695 for 20 consecutive trading days and the remaining 50% of such one third vests on the one year anniversary thereafter, (iii) for the final third of the shares, 50% vests upon the Company exceeding a market capitalization of \$282,330,695 for 20 consecutive trading days and the remaining 50% of such one third vests on the one year anniversary thereafter. If the vesting criteria is not met at the tenth anniversary of the grant date all unvested shares shall automatically be forfeited to the Company. Compensation expense will be recognized over the derived service period.

During the three months ended October, 31, 2007, the Company granted approximately 0.2 million non-vested shares of common stock to certain executives, under the 2003 Plan, at a weighted average grant date fair value of \$7.93 per share. These non-vested shares carry restrictions which lapse as the employees provide service as to one-third of the shares per annum on each of the first, second, and third anniversaries of the date of grant. With respect to 0.1 million of the non-vested shares, there was a potential for the restrictions to lapse on an earlier date as to 100% of the shares if the Company achieved certain revenue and EBITDA targets for its 2008 fiscal year. The targets were not met and the restrictions did not lapse on an accelerated basis. The grant date fair value of the non-vested shares was determined based on the market price of the Company's common stock on the date of grant.

The following table summarizes stock based compensation expense related to non-vested shares under SFAS 123R for the three months ended October 31, 2008 and October 31, 2007.

|                            | <b>Three Months Ended<br/>October 31,<br/>(in thousands)</b> |             |
|----------------------------|--|-------------|
|                            | <b>2008</b>  | <b>2007</b> |
| Cost of revenue            | \$ 42  | \$          |
| Selling and marketing      | 21   |             |
| General and administrative | 256  | 90          |
| Total                      | \$319  | \$90        |

The non-vested shares are excluded from our issued and outstanding share amounts presented in our Condensed Consolidated Balance Sheet at October 31, 2008.

***Employee Stock Purchase Plan***

Under the ESPP, employees who elect to participate instruct the Company to withhold a specified amount through payroll deductions during the offering period of six months. On the last business day of each offering period, the amount withheld is used to purchase the Company's common stock at an exercise price equal to 85% of the lower of the market price on the first or last business day of the offering period. During the three months ended October 31, 2008 and October 31, 2007, the Company did not issue any shares under the ESPP.

Compensation expense for the ESPP is recognized over the offering period. The following table summarizes stock based compensation expense related to the ESPP under SFAS 123R for the three months ended October 31, 2008 and October 31, 2007.

|                 | <b>Three Months Ended<br/>October 31,<br/>(in thousands)</b> |             |
|-----------------|--|-------------|
|                 | <b>2008</b>  | <b>2007</b> |
| Cost of revenue | \$28   | \$          |

|                            |      |  |    |
|----------------------------|------|--|----|
| Selling and marketing      | 14   |  |    |
| General and administrative | 11   |  |    |
| Total                      | \$53 |  | \$ |

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**(l) Net Loss Per Common Share**

Basic net loss per share is computed by dividing net loss by the weighted average number of common shares outstanding for the period. Diluted net loss per share is computed using the weighted average number of common and diluted common equivalent shares outstanding during the period. The Company utilizes the treasury stock method for options, warrants, and non-vested shares and the if-converted method for convertible preferred stock and notes, unless such amounts are anti-dilutive.

The following table sets forth common stock equivalents that are not included in the calculation of diluted net loss per share available to common stockholders because to do so would be anti-dilutive for the periods indicated.

|                                      | <b>Three Months Ended</b> |                  |
|--------------------------------------|---------------------------|------------------|
|                                      | <b>October 31</b>         |                  |
|                                      | <b>2008</b>               | <b>2007</b>      |
| Common stock options                 | 623,136                   | 2,961,330        |
| Common stock warrants                | 1,194,884                 | 1,422,997        |
| Nonvested stock                      | 26,496                    | 123,970          |
| Series A convertible preferred stock | 3,432,639                 | 3,159,722        |
| <b>Total</b>                         | <b>5,277,155</b>          | <b>7,668,019</b> |

**(m) Segment Reporting**

We currently operate in one segment, managed IT services. The Company's chief operating decision maker reviews financial information at a consolidated level.

**(n) Foreign Currency**

The functional currencies of our wholly-owned subsidiaries are the local currencies. The financial statements of the subsidiaries are translated into U.S. dollars using period end exchange rates for assets and liabilities and average exchange rates during corresponding periods for revenue, net, cost of revenue and expenses. Translation gains and losses are recorded as a separate component of stockholders' deficit.

**(o) Derivative Financial Instruments**

Derivative instruments are recorded in the balance sheet as either assets or liabilities, measured at fair value. Changes in fair value are recognized currently in earnings. The Company has utilized interest rate derivatives to mitigate the risk of rising interest rates on a portion of its floating rate debt and has not qualified for hedge accounting. The interest rate differentials to be received under such derivatives are recognized as adjustments to interest expense and the changes in the fair value of the instruments is recognized over the life of the agreements as Other income (expense), net. The principal objectives of the derivative instruments are to minimize the risks and reduce the expenses associated with financing activities. The Company does not use derivative financial instruments for trading purposes.

*Fair Value* - Effective August 1, 2008, the Company adopted Statement of Financial Accounting Standard No. 157 (SFAS No. 157), (*Fair Value Measurements*), which establishes a framework for measuring fair value and requires enhanced disclosures about fair value measurements. SFAS 157 requires disclosure about how fair value is determined for assets and liabilities and establishes a hierarchy for which these assets and liabilities must be grouped, based on significant levels of inputs as follows:

**Level 1** quoted prices in active markets for identical assets or liabilities;

**Level 2** quoted prices in active markets for similar assets and liabilities and inputs that are observable for the asset or liability; or



**Level 3** unobservable inputs, such as discounted cash flow models or valuations.

The determination of where assets and liabilities fall within this hierarchy is based upon the lowest level of input that is significant to the fair value measurement. The Company's interest rate derivatives required to be measured at fair value on a recurring basis and where they are classified within the hierarchy as of October 31, 2008.

|                           | Level 1 | Level 2 | Level 3   | Total     |
|---------------------------|---------|---------|-----------|-----------|
| Interest Rate Derivatives |         |         | \$ 86,000 | \$ 86,000 |
|                           |         |         | \$ 86,000 | \$ 86,000 |

Interest Rate Derivatives: The initial fair values of these instruments were determined by our counterparties and we continue to value these securities based on quotes from our counterparties. Since the inputs used to value these instruments are unobservable, we have classified them as level 3.

**(p) Recent Accounting Pronouncements**

In November 2008, the SEC issued for comment a proposed roadmap regarding the potential use by U.S. issuers of financial statements prepared in accordance with International Financial Reporting Standards ( IFRS ). IFRS is a comprehensive series of accounting standards published by the International Accounting Standards Board

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( IASB ). Under the proposed roadmap, the Company could be required in fiscal 2015 to prepare financial statements in accordance with IFRS, and the SEC will make a determination in 2011 regarding the mandatory adoption of IFRS. We are currently assessing the impact that this potential change would have on our consolidated financial statements, and we will continue to monitor the development of the potential implementation of IFRS.

In May 2008, the FASB issued Statement of Financial Accounting Standards No. 162, The Hierarchy of Generally Accepted Accounting Principles ( SFAS 162 ), which identifies the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental entities that are presented in conformity with U.S. GAAP. SFAS 162 is effective for the Company 60 days following the SEC's approval of the Public Company Accounting Oversight Board ( PCAOB ) amendments to AU Section 411, The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles. The adoption of SFAS 162 is not expected to have a material impact on our results of operations or financial position.

In April 2008, the FASB issued FSP FAS 142-3, Determination of the Useful Life of Intangible Assets ( FSP FAS 142-3 ). FSP FAS 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under FASB Statement No. 142, Goodwill and Other Intangible Asset. FSP FAS 142-3 is effective for the Company beginning in fiscal 2010. The Company is currently evaluating FSP FAS 142-3 and the impact, if any, that it may have on its results of operations or financial position.

In March 2008, the FASB issued Statement of Financial Accounting Standards No. 161 ( SFAS 161 ), Disclosures about Derivative Instruments and Hedging Activities an amendment of FASB Statement No. 133 . SFAS 161 requires enhanced disclosures about an entity's derivative and hedging activities and thereby improves the transparency of financial reporting. SFAS 161 is effective for fiscal years beginning on or after November 15, 2008. The Company is currently evaluating the impact that the adoption of SFAS 161 will have on its financial position, results of operations and cash flows.

In December 2007, the FASB issued SFAS No. 160, Non-controlling Interests in Consolidated Financial Statements, an amendment of ARB NO. 151, ( SFAS 160 ), which requires non-controlling interests (previously referred to as minority interest) to be treated as a separate component of equity, not as a liability as is current practice. SFAS 160 applies to non-controlling interests and transactions with non-controlling interest holders in consolidated financial statements. SFAS 160 is effective for periods beginning on or after December 15, 2008. We are currently evaluating the effect that SFAS 160 will have on our consolidated financial condition and results of operations.

In December 2007, the FASB issued SFAS No. 141(R), Business Combinations, ( SFAS 141R ), which requires most identifiable assets, liabilities, non-controlling interests, and goodwill acquired in a business combination to be recorded at full fair value. Under SFAS 141R, all business combinations will be accounted for under the acquisition method. Significant changes, among others, from current guidance resulting from SFAS 141R include the requirement that contingent assets and liabilities and contingent consideration shall be recorded at estimated fair value as of the acquisition date, with any subsequent changes in fair value charged or credited to earnings. Further, acquisition-related costs will be expensed rather than treated as part of the acquisition. SFAS 141R is effective for periods beginning on or after December 15, 2008. The Company is currently evaluating the effect, if any, that SFAS 141R will have on our consolidated financial condition and results of operations.

In February 2007, the FASB issued SFAS No. 159 ( SFAS 159 ), The Fair Value Option for Financial Assets and Liabilities . SFAS 159 permits entities to choose to measure many financial instruments and certain other items at fair value. SFAS 159 was adopted by the Company beginning August 1, 2008. The adoption of SFAS 159 did not have a material impact on the Company's consolidated financial position or results of operation.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements ( SFAS 157 ). SFAS 157 defines fair value, establishes a framework for measuring fair value in accordance with generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS 157 was adopted by the

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Company beginning August 1, 2008. The adoption of SFAS 157 did not have a material impact on the Company's consolidated financial position or results of operation.

**(3) Reclassifications**

Certain fiscal year 2008 amounts have been reclassified to conform to the current year presentation.

**(4) Discontinued Operations**

In August 2007, the Company launched America's Job Exchange ( AJE ), an employment services web site. This site utilizes technology developed in connection with the provision of services to a former customer. Upon termination of the use of the service by our customer, AJE was launched as an independent employment services site utilizing an advertising revenue and premium enhanced services model. In August 2007, the Company determined that AJE is not core to its business and pursuant to a plan developed in August 2007, the Company is actively seeking to dispose of AJE and, accordingly, the results of its operations, its assets and liabilities and its cash flows have been presented as discontinued operations in these condensed consolidated financial statements. The Company expects that AJE will be disposed of during fiscal year 2009. Subsequent to disposal, the Company does not expect to have any on-going involvement in the operations of AJE. Operating results related to AJE for the three months ended October 31, 2008 and 2007 were as follows:

|   | <b>Three months ended<br/>October 31</b> |         |
|---|--|---------|
|   | 2008                                     | 2007    |
|   | <b>(In thousands)</b>                    |         |
| Revenue   | \$304                                    | \$      |
| Cost of revenues                                      | 71                                       | 247     |
| Depreciation and amortization                         | 29                                       | 28      |
| Total cost of revenues                                | 100                                      | 275     |
| Gross profit (loss)                                   | 204                                      | (275)   |
| Operating expenses:                                   |  |         |
| Selling and marketing                                 | 221                                      | 39      |
| Loss from discontinued operations before income taxes | (17)                                     | (314)   |
| Income taxes  |  |         |
| Loss from discontinued operations, as reported        | \$ (17)                                  | \$(314) |

The recorded assets and liabilities of AJE at October 31, 2008 and July 31, 2008 were not material.

**(5) Restructuring Charge**

During the three months ended October 31, 2008, the Company initiated the restructuring of its professional services organization in an effort to realign resources. As a result of this initiative, the Company terminated several employees resulting in a restructuring charge for severance and related costs of \$0.5 million.



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The following is a roll forward of the restructuring accrual:

|   |    |       |
|---|----|-------|
| Restructuring accrual balance at July 31, 2008    | \$ |       |
| Restructuring and other related charges           |    | 476   |
| Cash payments and other settlements               |    | (160) |
| Restructuring accrual balance at October 31, 2008 | \$ | 316   |

The balance at October 31, 2008 is included in Accrued expenses and other current liabilities in the Company's Condensed Consolidated Balance Sheets. The remaining balance is expected to be paid during fiscal 2009.

**(6) Property and Equipment**

Property and equipment at October 31, 2008 and July 31, 2008 are summarized as follows:

|   | <b>October 31,<br/>2008</b> | <b>July 31,<br/>2008</b> |
|---|-----------------------------|--------------------------|
|   | <b>(In thousands)</b>       |                          |
| Office furniture and equipment                  | \$ 4,482                    | \$ 4,522                 |
| Computer equipment                              | 72,219                      | 68,968                   |
| Software licenses                               | 15,330                      | 15,270                   |
| Leasehold improvements                          | 25,113                      | 26,981                   |
|   | 117,144                     | 115,741                  |
| Less: Accumulated depreciation and amortization | (80,673)                    | (77,600)                 |
| Property and equipment, net                     | \$ 36,471                   | \$ 38,141                |

The estimated useful lives of our fixed assets are as follows: office furniture and equipment, 5 years; computer equipment, 3 years; software licenses, 3 years or life of the license; and leasehold improvements, lesser of the lease term or the asset's estimated useful life.

**(7) Goodwill and Intangible Assets**

|                                      |           |
|--------------------------------------|-----------|
| Goodwill balance at July 31, 2008    | \$ 66,683 |
| Adjustments to goodwill              | (117)     |
| Goodwill balance at October 31, 2008 | \$ 66,566 |

Goodwill was adjusted during the three months ending October 31, 2008, reflecting the finalization of purchase accounting reserves made within one year of the acquisition date.

Intangible assets, net consisted of the following:

|                | <b>October 31, 2008</b>              |                                     |                                    |
|----------------|--------------------------------------|-------------------------------------|------------------------------------|
|                | <b>Gross<br/>Carrying<br/>Amount</b> | <b>Accumulated<br/>Amortization</b> | <b>Net<br/>Carrying<br/>Amount</b> |
| Customer lists | \$39,670                             | \$(24,270)                          | \$ 15,400                          |

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|                           |          |            |          |
|---------------------------|----------|------------|----------|
| Customer contract backlog | 14,600   | (5,547)    | 9,053    |
| Developed technology      | 3,140    | (1,101)    | 2,039    |
| Vendor contracts          | 700      | (395)      | 305      |
| Trademarks                | 670      | (137)      | 533      |
| Non-compete agreements    | 206      | (84)       | 122      |
| Intangible assets, net    | \$58,986 | \$(31,534) | \$27,452 |

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|                           | <b>Gross<br/>Carrying<br/>Amount</b> | <b>July 31, 2008<br/>Accumulated<br/>Amortization</b> | <b>Net<br/>Carrying<br/>Amount</b> |
|---------------------------|--------------------------------------|---|------------------------------------|
| Customer lists            | \$39,670                             | \$(23,400)  | \$ 16,270                          |
| Customer contract backlog | 14,600                               | (4,845)   | 9,755                              |
| Developed technology      | 3,140                                | (966)   | 2,174                              |
| Vendor contracts          | 700                                  | (314)   | 386                                |
| Trademarks                | 670                                  | (105)   | 565                                |
| Non-compete agreements    | 206                                  | (66)  | 140                                |
| Intangible assets, net    | \$58,986                             | \$(29,696)  | \$ 29,290                          |

Intangible asset amortization expense for the three months ended October 31, 2008 and 2007 aggregated \$1.8 million and \$1.7 million, respectively. Intangible assets are being amortized over estimated useful lives ranging from two to eight years.

The amount reflected in the table below for fiscal year 2009 includes year to date amortization. Amortization expense related to intangible assets for the next five years is projected to be as follows:

| <b>Year Ending July 31,</b> | <b>(In thousands)</b> |
|-----------------------------|-----------------------|
| 2009                        | \$ 7,198              |
| 2010                        | \$ 6,068              |
| 2011                        | \$ 5,921              |
| 2012                        | \$ 5,776              |
| 2013                        | \$ 2,307              |

**(8) Accrued Expenses and Other Current Liabilities**

Accrued expenses and other current liabilities consist of the following:

|   | <b>October 31<br/>2008</b> | <b>July 31,<br/>2008</b> |
|---|----------------------------|--------------------------|
|   | <b>(In thousands)</b>      |                          |
| Accrued payroll, benefits and commissions           | \$ 5,111                   | \$ 4,561                 |
| Accrued accounts payable                            | 3,202                      | 3,256                    |
| Accrued interest                                    | 1,382                      | 1,367                    |
| Accrued lease abandonment costs, current portion    | 658                        | 857                      |
| Accrued sales/use, property and miscellaneous taxes | 504                        | 599                      |
| Accrued legal                                       | 390                        | 229                      |
| Other accrued expenses and current liabilities      | 2,307                      | 2,467                    |
|   | \$13,554                   | \$13,336                 |

**(9) Debt**

Debt consists of the following:

|   | <b>October<br/>31,<br/>2008</b> | <b>July 31,<br/>2008</b> |
|---|---------------------------------|--------------------------|
|   | <b>(In thousands)</b>           |                          |
| Total Debt                                  | \$ 112,367                      | \$ 113,950               |
| Less other notes payable                    | 692                             |                          |
| Total Term Loan and Revolver                | 111,675                         | 113,950                  |
| Less current portion Term Loan and Revolver | 4,100                           | 6,100                    |
| Long-term debt Term Loan                    | \$ 107,575                      | \$ 107,850               |

***Senior Secured Credit Facility***

In June 2007, the Company entered into a senior secured credit agreement (the Credit Agreement ) with a syndicated lending group. The Credit Agreement consisted of a six year single draw term loan (the Term Loan )



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totaling \$90.0 million and a five year \$10.0 million revolving credit facility (the Revolver ). Proceeds from the Term Loan were used to pay our obligations to Silver Point Finance LLC, to pay fees and expenses totaling approximately \$1.5 million related to the closing of the Credit Agreement, to provide financing for data center expansion (totaling approximately \$8.7 million) and for general corporate purposes. Borrowings under the Credit Agreement were guaranteed by the Company and certain of its subsidiaries.

Under the Term Loan, the Company is required to make principal amortization payments during the six year term of the loan in amounts totaling \$0.9 million per annum, paid quarterly on the first day of the Company's fiscal quarters. In April 2013, the balance of the Term Loan becomes due and payable. The outstanding principal under the Credit Agreement is subject to prepayment in the case of an Event of Default, as defined in the Credit Agreement. In addition, amounts outstanding under the Credit Agreement are subject to mandatory pre-payment in certain cases including, among others, a change in control of the Company, the incurrence of new debt and the issuance of equity of the Company. In the case of a mandatory pre-payment resulting from a debt issuance, 100% of the proceeds must be used to prepay amounts owed under the Credit Agreement. In the case of an equity offering, the Company was entitled to retain the first \$20.0 million raised and would prepay amounts owed under the Credit Agreement with 50% of the proceeds from an equity offering that exceed \$20.0 million.

Amounts outstanding under the Credit Agreement bore interest at either the LIBOR rate plus 3.5% or the Base Rate, as defined in the Credit Agreement, plus the Federal Funds Effective Rate plus 0.5%, at the Company's option. Upon the attainment of a Consolidated Leverage Ratio, as defined, of no greater than 3:1, the interest rate under the LIBOR option can decrease to LIBOR plus 3.0%. Interest becomes due and is payable quarterly in arrears. The Credit Agreement requires us to maintain interest rate arrangements to minimize exposure to interest rate fluctuations on an aggregate notional principal amount of 50% of amounts borrowed under the Term Loan.

The Credit Agreement requires us to maintain certain financial and non-financial covenants. Financial covenants include a minimum fixed charge coverage ratio, a maximum total leverage ratio and an annual capital expenditure limitation. At July 31, 2007 we had exceeded the maximum allowable annual capital expenditures under the terms of the Credit Agreement for the fiscal year ended July 31, 2007. In September 2007, in connection with the Amended Credit Agreement (defined below), we received an increase in the maximum allowable annual capital expenditures for the fiscal year ended July 31, 2007, which waived the violation as of July 31, 2007. Non-financial covenants include restrictions on our ability to pay dividends, make investments, sell assets, enter into merger or acquisition transactions, incur indebtedness or liens, enter into leasing transactions, alter our capital structure or issue equity, among others. In addition, under the Credit Agreement, we are allowed to borrow, through one or more of our foreign subsidiaries, up to \$10.0 million to finance data center expansion in the United Kingdom.

Proceeds from the Term Loan were used to extinguish all of the Company's outstanding debt with Silver Point Finance LLC. At the closing of the Credit Agreement, the Company had \$75.5 million outstanding with Silver Point Finance LLC, which was paid in full. In addition, the Company incurred a \$3.0 million pre-payment penalty which was paid with the proceeds of the Term Loan.

In August 2007, the Company entered into Amendment, Waiver and Consent Agreement No. 1 to the Credit Agreement (the Amendment ). The Amendment permitted us to use approximately \$8.7 million of cash originally borrowed under the Credit Agreement, which was restricted for data center expansion to partially fund the acquisition of Jupiter and Alabanza and amended the Credit Agreement to permit the issuance of up to \$75.0 million of Permitted Indebtedness, as defined. Permitted Indebtedness must be unsecured, require no amortization payment and not become due or payable until 180 days after the maturity date of the Credit Agreement in June 2013.

In September 2007, the Company entered into an Amended and Restated Credit Agreement ( Amended Credit Agreement ). The Amended Credit Agreement provided the Company with an incremental \$20.0 million in term loan borrowings and amended the rate of interest to LIBOR plus 4.0%, with a step-down to LIBOR plus 3.5% upon attainment of a 3:1 leverage ratio. All other terms of the Credit Agreement remained substantially the same. The Company recorded a loss on debt extinguishment of approximately \$1.7 million for the six months ended January 31,

2008 to reflect this extinguishment of the Credit Agreement, in accordance with EITF 96-19 Debtor's Accounting for a Modification or Exchange of Debt Instruments.

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In January 2008, the Company entered into Amendment, Waiver and Consent Agreement No. 3 to the Amended Credit Agreement (the January Amendment). The January Amendment amended the definition of Permitted UK Datasite Buildout Indebtedness (as that term is defined in the Amended Credit Agreement) to total \$16.5 million as compared to \$10.0 million and requires the reduction of the \$16.5 million to no less than \$10.0 million as such indebtedness is repaid as to principal.

In June 2008, the Company entered into Amendment and Consent Agreement No. 4 to the Amended Credit Agreement (the June Amendment). The June Amendment (i) amended the definition of Permitted UK Datasite Buildout Indebtedness (as that term is defined in the Amended Credit Agreement) to total \$33.0 million as compared to \$16.5 million, (ii) increased to \$20.0 million the maximum amount of contingent obligations relating to all leases for any period of twelve months, and (iii) increased the rate of interest to either (x) LIBOR rate plus 5.0% or (y) Base Rate, as defined in the Amended Credit Agreement, plus 4.0%.

At July 31, 2008, the Company was not in compliance with its financial covenants of leverage, fixed charges and annual capital expenditures. In October 2008, the Company entered into Amendment, Waiver and Consent Agreement No. 5 to the Amended Credit Agreement (the October Amendment). The October Amendment (i) waived the existing covenant violations as of July 31, 2008, (ii) increased the rate of interest to either (x) LIBOR rate plus 6% or (y) Base Rate, as defined in the Amended Credit Agreement, plus 5%, (iii) added a 2% accruing payment-in-kind (PIK) interest until the leverage ratio has been lowered to 3:1, (iv) changed the excess cash flow sweep to 75% to be performed quarterly, (v) required certain settlement and asset sale proceeds to be used for debt repayment, (vi) modified certain financial covenants for future periods, and (vii) requires a payment to the lenders of 3% the outstanding term and revolving loans if a leverage ratio of 3:1 is not achieved by January 31, 2010.

At October 31, 2008, \$111.7 million was outstanding under the Amended Credit Agreement of which \$3.0 million was outstanding under the Revolver.

**(10) Derivative Instruments**

In May 2006, the Company purchased an interest rate cap on a notional amount of 70% of the then outstanding principal of the Silver Point Debt. The Company paid approximately \$320,000 to lock in a maximum variable interest rate of 6.5% that could be charged on the notional amount during the term of the agreement. In June 2007, upon refinancing of the Silver Point Debt, the Company maintained the interest rate cap, as the Credit Agreement required a minimum notional amount of 50% of the outstanding principal of the Credit Agreement. In October 2007, in connection with the execution of the Amended Credit Agreement in September 2007 (see Note 9), the Company purchased a second interest rate cap totaling \$10.0 million of notional amount, as the Amended Credit Agreement required a minimum notional amount of 50% of all Indebtedness, as defined in the Amended Credit Agreement. As of October 31, 2008 the fair value of these interest rate derivatives (representing a notional amount of approximately \$54 million at October 31, 2008) was approximately \$86,000 which is included in Other Assets in the Company's Condensed Consolidated Balance Sheets. The change in fair value for the three months ended October 31, 2008 and 2007, respectively was approximately \$4,000 and \$70,000. The change in fair value was charged to Other income, net in the accompanying Condensed Consolidated Statements of Operation.

**(11) Commitments and Contingencies****(a) Leases**

*Abandoned Leased Facilities.* During fiscal year 2008, in connection with the acquisitions of Jupiter and netASPx, the Company recorded impairment accruals for four facilities—two in Santa Clara, CA, one in Herndon, VA and one in Minneapolis, MN. The Santa Clara facilities and the Herndon, VA facility were vacated shortly after the acquisition of Jupiter and netASPx, respectively, pursuant to a plan of closure and relocation. The Minneapolis office space was underutilized as of the date of acquisition of netASPx and the recorded impairment accrual reflects this underutilized space. The initial impairment accruals related to these facilities was approximately \$1.1 million.

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During the three months ended October 31, 2008, we recorded no lease impairment.

Details of activity in the lease exit accrual by geographic region for the three months ended October 31, 2008 are as follows (in thousands):

| <b>Lease Abandonment Costs for:</b> | <b>Balance<br/>July 31,<br/>2008</b> | <b>Expense<br/>(Recovery)</b> | <b>Purchase<br/>Accounting<br/>and<br/>Other<br/>Adjustments</b> | <b>Payments,<br/>less<br/>accretion of<br/>interest</b> | <b>Balance<br/>October<br/>31,<br/>2008</b> |
|-------------------------------------|--------------------------------------|-------------------------------|--|---|---|
| Andover, MA                         | \$ 262                               | \$                            | \$   | \$ (32)   | \$ 230                                      |
| Chicago, IL                         | 250                                  |                               |  | (72)  | 178   |
| Houston, TX                         | 113                                  |                               |  | (84)  | 29  |
| Syracuse, NY                        | 21                                   |                               |  | (6)   | 15  |
| Santa Clara, CA                     | 77                                   |                               |  | (23)  | 54  |
| Herndon, VA                         | 56                                   |                               |  | (6)   | 50  |
| Minneapolis, MN                     | 506                                  |                               |  | (70)  | 436   |
|                                     | \$ 1,285                             | \$                            | \$   | \$ (293)  | \$ 992                                      |

Minimum annual rental commitments under operating leases and other commitments are as follows as of October 31, 2008:

| <b>Description</b>                         | <b>Total</b>      | <b>Less<br/>than<br/>1 Year</b> | <b>Year 2</b>    | <b>Year 3</b>         | <b>Year 4</b>    | <b>Year 5</b>     | <b>After<br/>Year 5</b> |
|--|-------------------|---------------------------------|------------------|-----------------------|------------------|-------------------|-------------------------|
|  |                   |                                 |                  | <b>(In thousands)</b> |                  |                   |                         |
| Short/Long-term debt                       | \$ 115,412        | \$ 4,792                        | \$ 1,100         | \$ 1,100              | \$ 1,100         | \$ 107,320        | \$                      |
| Interest on debt <sup>(a)</sup>            | 46,777            | 10,063                          | 10,186           | 10,126                | 10,028           | 6,374             |                         |
| Capital leases <sup>(a)</sup>              | 25,675            | 5,081                           | 3,686            | 2,382                 | 2,374            | 2,427             | 9,725                   |
| Bandwidth commitments                      | 2,858             | 2,135                           | 723              |                       |                  |                   |                         |
| Property leases <sup>(a) (b) (c) (d)</sup> | 81,991            | 11,881                          | 9,759            | 8,697                 | 8,752            | 8,900             | 34,002                  |
| <b>Total</b>                               | <b>\$ 272,713</b> | <b>\$ 33,952</b>                | <b>\$ 25,454</b> | <b>\$ 22,305</b>      | <b>\$ 22,254</b> | <b>\$ 125,021</b> | <b>\$ 43,727</b>        |

(a) Interest on debt assumes Libor is fixed at 3.16% and that Company's leverage ratio drops below 3:1 as of January

2010. Based on this the interest rate drops by 2%. Future commitments denominated in foreign currency are fixed at the exchange rate as of October 31, 2008.

- (b) Amounts exclude certain common area maintenance and other property charges that are not included within the lease payment.
- (c) On February 9, 2005, the Company entered into an Assignment and Assumption Agreement with a Las Vegas-based company, whereby this company purchased from us the right to use 29,000 square feet in our Las Vegas data center, along with the infrastructure and equipment associated with this space. In exchange, we received an initial payment of \$600,000 and were to receive

\$55,682 per month over two years. On May 31, 2006, we received full payment for the remaining unpaid balance. This agreement shifts the responsibility for management of the data center and its employees, along with the maintenance of the facility's infrastructure, to this Las Vegas-based company. Pursuant to this agreement, we have subleased back 2,000 square feet of space, allowing us to continue servicing our existing customer base in this market. Commitments related to property leases include an amount related to the 2,000 square feet sublease.

- (d) In July 2008, the Company entered into a lease agreement for approximately 11,000 square feet of data center space in

the U.K. (see Note 13). The Company has not yet accepted delivery of the data center and therefore the future committed property lease amounts are not reflected as of October 31, 2008.

Total bandwidth expense was \$1.4 million and \$1.5 million for the three months ended October 31, 2008 and 2007, respectively.

Total rent expense for property leases was \$3.3 million and \$3.1 million for the three months ended October 31, 2008 and 2007, respectively.

With respect to the property lease commitments listed above, certain cash amounts are restricted pursuant to terms of lease agreements with landlords. At October 31, 2008, restricted cash of approximately \$1.9 million

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related to these lease agreements and consisted of certificates of deposit and a treasury note and are recorded at cost, which approximates fair value.

**(b) Legal Matters***IPO Securities Litigation*

In 2001, lawsuits naming more than 300 issuers and over 50 investment banks were filed in the United States District Court for the Southern District of New York and assigned to the Honorable Shira A. Scheindlin (the Court) for all pretrial purposes (the IPO Securities Litigation). Between June 13, 2001 and July 10, 2001 five purported class action lawsuits seeking monetary damages were filed against us, Joel B. Rosen, our then chief executive officer, Kenneth W. Hale, our then chief financial officer, Robert E. Eisenberg, our then president, and the underwriters of our initial public offering of October 22, 1999. On September 6, 2001, the Court consolidated the five similar cases and a consolidated, amended complaint was filed on April 19, 2002 (the Class Action Litigation) against us and Messrs. Rosen, Hale and Eisenberg (collectively, the NaviSite Defendants) and against underwriter defendants Robertson Stephens (as successor-in-interest to BancBoston), BancBoston, J.P. Morgan (as successor-in-interest to Hambrecht & Quist), Hambrecht & Quist and First Albany. The plaintiffs uniformly alleged that all defendants, including the NaviSite Defendants, violated Sections 11 and 15 of the Securities Act of 1933, Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5 by issuing and selling our common stock in the offering, without disclosing to investors that some of the underwriters, including the lead underwriters, allegedly had solicited and received undisclosed agreements from certain investors to purchase aftermarket shares at pre-arranged, escalating prices and also to receive additional commissions and/or other compensation from those investors. The Class Action Litigation seeks certification of a plaintiff class consisting of all persons who acquired shares of our common stock between October 22, 1999 and December 6, 2000. The claims against Messrs. Rosen, Hale and Eisenberg were dismissed without prejudice on November 18, 2002, in return for their agreement to toll any statute of limitations applicable to those claims. At this time, plaintiffs have not specified the amount of damages they are seeking in the Class Action Litigation. On October 13, 2004, the Court certified a class in a sub-group of cases (the Focus Cases) in the IPO Securities Litigation, which was vacated on December 5, 2006 by the United States Court of Appeals for the Second Circuit (the Second Circuit). The Class Action Litigation is not one of the Focus Cases. Plaintiffs-appellees January 5, 2007 petition with the Second Circuit for rehearing and rehearing en banc was denied by the Second Circuit on April 6, 2007. Plaintiffs renewed their certification motion in the Focus Cases on September 27, 2007 as to redefined classes pursuant to Fed. R. Civ. P. 23(b)(3) and 23(c)(4). On October 3, 2008, after briefing, in connection with the renewed class certification proceedings was completed, plaintiffs withdrew without prejudice the renewed certification motion in the Focus Cases. On October 10, 2008, the Court confirmed plaintiffs' request and directed the clerk to close the renewed certification motion. Additionally, on August 14, 2007, plaintiffs filed amended class action complaints in the Focus Cases, along with an accompanying set of Amended Master Allegations (collectively, the Amended Complaints). Plaintiffs therein (i) revise their allegations with respect to (1) the issue of investor knowledge of the alleged undisclosed agreements with the underwriter defendants and (2) the issue of loss causation; (ii) include new pleadings concerning alleged governmental investigations of certain underwriters; and (iii) add additional plaintiffs to certain of the Amended Complaints. On March 26, 2008, the Court entered an order granting in part and denying in part the motions to dismiss filed by the defendants named in the Focus Cases. Specifically, the Court dismissed the Section 11 claims brought by plaintiffs (1) who lacked recoverable Section 11 damages and (2) whose claims were time barred, but otherwise denied the motions as to the other claims alleged in the Amended Complaints.

On October 12, 2007, a purported shareholder of the Company filed a complaint for violation of Section 16(b) of the Securities Exchange Act of 1934, which prohibits short-swing trading, against two of the underwriters of the public offering at issue in the Class Action Litigation. The complaint is pending in the United States District Court for the Western District of Washington and is captioned Vanessa Simmonds v. Bank of America Corp., et al. An amended complaint was filed on February 28, 2008. Plaintiff seeks the recovery of short-swing profits from the underwriters on behalf of the Company, which is named only as a nominal defendant and from whom no recovery is sought. Similar



complaints have been filed against the underwriters of the public offerings of approximately 55 other issuers also involved in the IPO Securities Litigation. A joint status conference was held on April 28, 2008, at which the Court stayed discovery and ordered the parties to file motions to dismiss by July 25, 2008. On July 25, 2008, the

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Company joined 29 other nominal defendant issuers and filed Issuer Defendants Joint Motion to Dismiss the Amended Complaint. On the same date, the Underwriter Defendants also filed a Joint Motion to Dismiss. On September 8, 2008, plaintiff filed her oppositions to the motions. The replies in support of the motions to dismiss were filed on October 23, 2008. Oral arguments on all motions to dismiss are scheduled for January 16, 2009.

We believe that the allegations against us are without merit and we intend to vigorously defend against the plaintiffs claims. Due to the inherent uncertainty of litigation, we are not able to predict the possible outcome of the suits and their ultimate effect, if any, on our business, financial condition, results of operations or cash flows.

***Other litigation***

In October 2007, the Company, pursuant to its integration plans, closed the former Alabanza data center in Baltimore, Maryland and moved all equipment to the Company's data center in Andover, Massachusetts (the Data Migration). In connection with the Data Migration, the Company encountered unforeseen circumstances which led to extended down-time for certain of its customers.

On November 14, 2007, Pam Kagan Marketing, Inc., d/b/a Earthplaza, filed a complaint in the United States District Court for the District of Maryland (the Court) against the Company and Alabanza Corporation seeking a class status for the customers who experienced web hosting service interruptions as a result of the Data Migration (the November Class Action Litigation). The total damages claimed approximate \$5.0 million. On January 4, 2008, Palmatec, LLC, NYC Merchandise and Taglogic RFID, Ltd. filed a complaint in the Maryland State Court, Circuit Court for Baltimore against the Company seeking a class status for the direct customers (the Direct Subclass) and the entities that purchased hosting services from those direct customers (the Non-Privy Subclass) (the January Class Action Litigation). The total damages claimed approximate \$10.0 million. The January Class Action Litigation was removed to the Court by the Company. On May 11, 2008, the Court issued an order consolidating the two cases. On August 5, 2008, the plaintiffs in the January Class Action Litigation voluntarily withdrew their case, without prejudice, because of the inadequacy of their class representative. The claims of the Direct Subclass continue to be litigated in the November Class Action Litigation. The Company believes that the potential plaintiffs in the combined class action may be denied class status and further, that the plaintiffs claims are without merit. The Company plans to defend itself vigorously; however, at this time, due to the inherent uncertainty of litigation, we are not able to predict the possible outcome of the suit and its ultimate effect, if any, on our business, financial condition, results of operations or cash flows.

**(12) Income Tax Expense**

The Company recorded \$0.5 million and \$0.4 million of deferred income tax expense during the three months ended October 31, 2008 and 2007, respectively. No deferred tax benefit was recorded for the losses incurred due to a valuation allowance recognized against deferred tax assets. The deferred tax expense results from tax goodwill amortization related to the acquisitions of Surebridge, Inc., AppliedTheory Corporation, netASPx, Alabanza and iCommerce, Inc. For financial statement purposes, goodwill is not amortized for any acquisitions but is tested for impairment annually. Tax amortization of goodwill results in a taxable temporary difference, which will not reverse until the goodwill is impaired or written off. The resulting taxable temporary difference may not be offset by deductible temporary differences currently available, such as net operating loss carryforwards which expire within a definite period.

On August 1, 2007, the Company adopted the provisions of Financial Accounting Standards Board Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48). The purpose of FIN 48 is to increase the comparability in financial reporting of income taxes. FIN 48 requires that in order for a tax benefit to be recorded in the income statement, the item in question must meet the more-likely-than-not (greater than 50% likelihood of being sustained upon examination by the taxing authorities) threshold. The adoption of FIN 48 did not have a material effect on the Company's financial statements. No cumulative effect was booked through beginning retained earnings.

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The Company is not currently under audit by the Internal Revenue Service or a similar equivalent for the foreign jurisdictions in which the Company files tax returns. The Company conducts business in multiple locations throughout the world resulting in tax filings outside of the United States. The Company is subject to tax examinations regularly as part of the normal course of business. The Company's major jurisdictions are the United States, the United Kingdom and India. With few exceptions, the Company is no longer subject to United States federal, state and local, or non-U.S. income tax examinations for fiscal years before 2004. However, years prior to fiscal 2004 remain open to examination by United States federal and state revenue authorities to the extent of future utilization of net operating losses generated in each preceding year.

The Company records interest and penalty charges related to income taxes, if incurred, as a component of general and administrative expenses.

**(13) Related Party Transactions**

During the three months ended October 31, 2008 and 2007, respectively the Company generated revenue from three related parties, ClearBlue Technologies (UK) Limited, and two separate entities who are affiliated with our Chief Executive Officer, totaling approximately \$83,000 and \$75,000, respectively. As of October 31, 2008, the net amount due from Clearblue Technologies (UK) Limited was not significant and the amount owed from the remaining two related parties totaled approximately \$0.1 million. ClearBlue Technologies (UK) Limited is controlled by the Company's Chairman of the Board of Directors.

On February 4, 2008, our subsidiary NaviSite Europe Limited, with the Company as guarantor, entered into a Lease Agreement (the "Lease") for approximately 10,000 square feet of data center space located in Watford, Hertfordshire, England (the "Data Center") with Sentrum III Limited. The Lease has a ten year term. NaviSite Europe Limited and the Company are also parties to a Services Agreement with Sentrum Services Limited for the provision of services within the data center. At October 31, 2008, the Company had capital lease obligations totaling \$11.7 million related to equipment under the lease agreements. During the three months ended October 31, 2008, the Company paid \$0.6 million under these arrangements. Our Chairman of the Board of Directors has a financial interest in each of Sentrum III Limited and Sentrum Services Limited.

In November 2007, our subsidiary NaviSite Europe Limited, with the Company as guarantor, entered into a lease option agreement for data center space in Woking, Surrey, England with Sentrum IV Limited. As part of this lease option agreement the Company made a fully refundable deposit of \$5.0 million in order to secure the right to lease the space upon the completion of the building construction. In July 2008, the final lease agreement was completed for approximately 11,000 square feet of data center space. In August 2008, the deposit was returned to the Company. Our Chairman of the Board of Directors has a financial interest in Sentrum IV Limited.

**(14) Subsequent Event**

On November 6, 2008, the Company was notified by the NASDAQ Listing Qualification Staff (the "Staff") that it was not in compliance with the NASDAQ Marketplace Rule 4310(c)(3) (the "Rule"), which requires the Company to have a minimum of \$2,500,000 in stockholders' equity, \$35,000,000 market value of listed securities or \$500,000 in income from continuing operations for the most recently completed fiscal year or two of the three most recently completed fiscal years. On November 21, 2008, the Company responded to the Staff summarizing the Company's plan to achieve and sustain compliance with all NASDAQ Capital Market listing requirements and on December 12, 2008, the Staff granted the Company an extension to February 19, 2009 to regain compliance with the Rule.

**Table of Contents****Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended, and Section 27A of the Securities Act of 1933, as amended, that involve risks and uncertainties. All statements other than statements of historical information provided herein are forward-looking statements and may contain information about financial results, economic conditions, trends and known uncertainties. Our actual results could differ materially from those discussed in the forward-looking statements as a result of a number of factors, which include those discussed in this section and elsewhere in this report under Item 1A. Risk Factors and in our annual report on Form 10-K under Item 1A. Risk Factors and the risks discussed in our other filings with the Securities and Exchange Commission. Readers are cautioned not to place undue reliance on these forward-looking statements, which reflect management's analysis, judgment, belief or expectation only as of the date hereof. We undertake no obligation to publicly revise these forward-looking statements to reflect events or circumstances that arise after the date hereof.

**Overview**

NaviSite is an enterprise hosting and application service provider to middle market companies. We offer a range of hosting and Enterprise Resource Planning ( ERP ) application solutions to our customer, helping them to achieve a scalable, outsourced technology solution at lower total cost of ownership. Leveraging our set of technologies and subject matter expertise, we deliver cost-effective, flexible solutions that provide responsive and predictable levels of service for our customers' businesses. We provide services throughout the information technology lifecycle and are dedicated to delivering quality services and meeting rigorous standards, including maintenance of SAS 70 Type II compliance and Microsoft Gold, and Oracle Certified Partner certifications.

We believe that by leveraging economies of scale utilizing our global delivery approach, industry best practices and process automation, our services enable our customers to achieve significant cost savings. In addition to delivering enterprise hosting and application services, we are able to leverage our infrastructure and application management platform, NaviView™, to enable our partners' software to be delivered on-demand, providing an alternative delivery model to the traditional licensed software model. As the platform provider for an increasing number of independent software vendors ( ISV ), we enable solutions and services to a wider and growing customer base.

Our services include:

**Enterprise Hosting Services**

Platform as a Service Hardware and software support delivered from one of our 16 data centers. Services include dedicated and virtualized hosting, business continuity and disaster recovery, connectivity, content distribution, database administration and performance tuning, hardware management, monitoring, network management, security management, server and operating system management and storage management.

Software as a Service ( SaaS ) Enablement of SaaS to the ISV community. Services include SaaS starter kits and services specific to the needs of ISVs who offer their software in an on-demand or subscription model.

Co-location Physical space offered in a data center. In addition to providing the physical space, NaviSite offers environmental support, specified power with back-up power generation and network connectivity options.

**Application Services**

ERP Application and Messaging Management Services Customer defined services for specific packaged applications.

Applications include:

Oracle e-Business Suite

PeopleSoft Enterprise

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Siebel

JD Edwards

Hyperion

Lawson

Kronos

Microsoft Dynamics

Microsoft Exchange

Lotus Notes

Services include implementation, upgrade support, monitoring, diagnostics, problem resolution and functional end-user support.

ERP Professional Services Planning, implementation, optimization, enhancement and upgrade support for third party ERP applications we support.

Custom Development Services Planning, implementation, optimization and enhancement for custom applications that we or our customers have developed.

We provide these services to a range of vertical industries, including financial services, healthcare and pharmaceutical, manufacturing and distribution, publishing, media and communications, business services and public sector and software, through both our own sales force and sales channel relationships.

Our managed application and hosting services are facilitated by our proprietary NaviView™ collaborative infrastructure and application management platform. Our NaviView™ platform enables us to provide highly efficient, effective and customized management of enterprise applications and hosted infrastructure. Comprised of a suite of third-party and proprietary products, NaviView™ provides tools designed specifically to meet the needs of customers who outsource their IT needs.

Supporting both our managed hosting services and applications services is a range of hardware and software technologies designed for the specific needs of our customers. NaviSite is a leader in using virtualized processing, storage and networking as a platform to optimize services for performance, cost and operational efficiency. Utilizing both hardware and software based virtualization strategies, NaviSite continues to innovate as technology develops.

We believe that the combination of NaviView™, our dedicated and virtual platform, with our physical infrastructure and technical staff gives us a unique ability to provide complex enterprise hosting and application services for mid-market customers. NaviView™ is application and operating system neutral. Designed to enable enterprise hosting and software applications to be monitored and managed, the NaviView™ technology allows us to offer new solutions to our software vendors and new products to our current customers.

We provide our services from a global platform of 14 data centers in the United States, two in the United Kingdom and a Network Operations Center ( NOC ) in India. We believe that our data centers and infrastructure have the capacity necessary to expand our business for the foreseeable future. Further, trends in hardware virtualization and the density of computing resources, which reduce footprint in the data center, are favorable to NaviSite's services-oriented offerings as compared with traditional co-location or managed hosting providers. Our services combine our developed infrastructure with established processes and procedures for delivering hosting and application management services. Our high availability infrastructure, high performance monitoring systems, and proactive and collaborative problem resolution and change management processes are designed to identify and address potentially crippling problems before they disrupt our customers' operations.

We currently service over 1,400 customers. Our hosted customers typically enter into service agreements for a term of one to five years, which provide for monthly payment installments, providing us with a base of recurring revenue. Our revenue growth comes from adding new customers or delivering additional services to existing customers. Our recurring revenue base is affected by new customers, renewals and terminations of agreements with existing customers.

During fiscal 2008 and in past years, we have grown through business acquisitions and have restructured our operations. Specifically, in December 2002, we completed a common control merger with ClearBlue Technologies

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Management, Inc.; in February 2003, we acquired Avasta, Inc.; in April 2003, we acquired Conxion Corporation; in May 2003, we acquired assets of Interliant, Inc. in August 2003 and April 2004, we completed a common control merger with certain subsidiaries of ClearBlue Technologies, Inc.; and in June 2004, we acquired substantially all of the assets and liabilities of Surebridge (now known as Waythere, Inc.). In January 2005, we formed NaviSite India Private Limited ( NaviSite India ), a New Delhi-based operation which is intended to expand our international capability. NaviSite India provides a range of software services, including design and development of custom and E-commerce solutions, application management, problem resolution management and the deployment and management of IT networks, customer specific infrastructure and data center infrastructure. We expect to make additional acquisitions to take advantage of our available capacity, which will have significant effects on our financial results in the future.

In August 2007, we acquired the assets of Alabanza, LLC and Hosting Ventures, LLC (collectively Alabanza ) and all of the issued and outstanding stock of Jupiter Hosting, Inc. ( Jupiter ). These acquisitions provided additional managed hosting customers, proprietary software for provisioning and additional data center space in the Bay Area market. In September 2007, we acquired netASPx, Inc. ( netASPx ), an application management service provider, and in October 2007, we acquired the assets of iCommerce, Inc., a re-seller of dedicated hosting services.

**Results of Operations for the Three Months Ended October 31, 2008 and 2007**

The following table sets forth the percentage relationships of certain items from our Condensed Consolidated Statements of Operations as a percentage of total revenue for the periods indicated.

|  | <b>Three Months Ended<br/>October 31,</b> |             |
|--|---|-------------|
|  | <b>2008</b>                               | <b>2007</b> |
| Revenue, net   | 99.8%                                     | 99.8%       |
| Revenue, related parties   | 0.2%                                      | 0.2%        |
| Total revenue  | 100.0%                                    | 100.0%      |
| Cost of revenue, excluding restructuring charge, depreciation and amortization | 54.5%                                     | 57.8%       |
| Depreciation and amortization  | 14.3%                                     | 11.6%       |
| Restructuring charge   | 0.5%                                      |             |
| Total cost of revenue  | 69.3%                                     | 69.4%       |
| Gross profit   | 30.7%                                     | 30.6%       |
| Operating expenses:  |   |             |
| Selling and marketing  | 13.7%                                     | 14.3%       |
| General and administrative   | 15.0%                                     | 15.6%       |
| Restructuring Charge   | 0.6%                                      |             |
| Total operating expenses   | 29.3%                                     | 29.9%       |
| Income from operations   | 1.4%                                      | 0.7%        |
| Other income (expense):  |   |             |
| Interest income  |   | 0.3%        |
| Interest expense   | (7.7)%                                    | (7.3)%      |
| Loss on debt extinguishment  |   | (4.6)%      |

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|   |        |         |
|---|--------|---------|
| Other income (expense), net   | 1.2%   | 0.8%    |
| Loss from continuing operations before income taxes and discontinued operations | (5.1)% | (10.1)% |
| Income taxes  | (1.2)% | (1.1)%  |



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|  | <b>Three Months Ended<br/>October 31,</b> |             |
|--|---|-------------|
|  | <b>2008</b>                               | <b>2007</b> |
| Loss from continuing operations before discontinued operations | (6.3)%                                    | (11.2)%     |
| Discontinued operations, net of income taxes                   | ( )%                                      | (0.9)%      |
| Net loss   | (6.3)%                                    | (12.1)%     |
| Accretion of preferred stock dividends                         | (2.0)%                                    | (1.1)%      |
| Net loss attributable to common stockholders                   | (8.3)%                                    | (13.2)%     |

**Comparison of the Three Months Ended October 31, 2008 and 2007****Revenue**

We derive our revenue from managed IT services, including hosting, co-location and application services comprised of a variety of service offerings and professional services, to mid-market companies and organizations, including mid-sized companies, divisions of large multi-national companies and government agencies.

Total revenue for the three months ended October 31, 2008 increased 10.4% to approximately \$39.9 million from approximately \$36.1 million for the three months ended October 31, 2007. The overall growth of approximately \$3.8 million in revenue was mainly due to increased sales to new and existing NaviSite customers and the inclusion of a full quarter of revenue from acquisitions made during the same period in the prior year. The Company's enterprise hosting and application services revenues increased \$5.3 million due to increased sales to new and existing customers. Professional services revenues declined \$2.3 million in the current year as compared to the prior year due to lower sales of these types of services. Revenue from related parties during the three months ended October 31, 2008 and 2007 totaled \$83,000 and \$75,000, respectively.

**Cost of Revenue and Gross Profit**

Cost of revenue consists primarily of salaries and benefits for operations personnel, bandwidth fees and related Internet connectivity charges, equipment costs and related depreciation and costs to run our data centers, such as rent and utilities.

Total cost of revenue for the three months ended October 31, 2008 increased approximately 10.4% to \$27.6 million during the three months ended October 31, 2008 from approximately \$25.0 million during the three months ended October 31, 2007. As a percentage of revenue, total cost of revenue increased to 69.3% during the three months ended October 31, 2008 from 69.4% during the three months ended October 31, 2007. The overall increase of approximately \$2.6 million was primarily due to increased depreciation expense of approximately \$1.5 million, increased facilities related expense including rent and utilities of approximately \$1.1 million, increased third party pass through related expenses of approximately \$0.6 million, increased outside consultant expenses of \$0.4 million and increased software and hardware maintenance and licensing costs of approximately \$0.3 million. These incremental expenses of approximately \$3.9 million were partially offset by lower salary related expenses of approximately \$1.1 million during the period and \$0.2 million of acquisition costs incurred in the prior year.

During the three months ended October 31, 2008, the Company initiated the restructuring of its professional services organization in an effort to realign resources. As a result of this initiative, the Company terminated several employees resulting in a restructuring charge for severance and related costs of \$0.5 million, of which approximately \$0.2 million was included in Cost of Revenue.

Gross profit of approximately \$12.2 million for the three months ended October 31, 2008 increased approximately \$1.1 million, or 10.4%, from a gross profit of approximately \$11.1 million for the three months ended October 31, 2007. Gross profit for the three months ended October 31, 2008 represented 30.7% of total revenue, compared to 30.6% of total revenue for the three months ended October 31, 2007. Gross profit was positively impacted during the three months ended October 31, 2008 as compared to the three months ended October 31, 2007, mainly due to the

increased revenues noted above.

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*Selling and Marketing.* Selling and marketing expense consists primarily of salaries and related benefits, commissions and marketing expenses such as traveling, advertising, product literature, trade show, and marketing and direct mail programs.

Selling and marketing expense increased 5.3% to approximately \$5.4 million, or 13.7% of total revenue, during the three months ended October 31, 2008 from approximately \$5.2 million, or 14.3% of total revenue, during the three months ended October 31, 2007. The increase of approximately \$0.2 million resulted primarily from the increased salary and related headcount expenses of \$0.1 million, and increased lead referral fees of approximately \$0.1 million.

*General and Administrative.* General and administrative expense includes the costs of financial, human resources, IT and administrative personnel, professional services, bad debt and corporate overhead.

General and administrative expense increased 6.0% to approximately \$6.0 million, or 15.0% of total revenue, during the three months ended October 31, 2008 from approximately \$5.6 million, or 15.6% of total revenue, during the three months ended October 31, 2007. The mix of expenses changed such that there was an increase in accounting and legal fees of approximately \$0.3 million, an increase in utilities expense of approximately \$0.2 million partially offset by lower depreciation expense of approximately \$0.1 million.

**Operating Expenses Impairment, Restructuring, and Other**

During the three months ended October 31, 2008, the Company initiated the restructuring of its professional services organization in an effort to realign resources. As a result of this initiative, the Company terminated several employees resulting in a restructuring charge for severance and related costs of \$0.5 million, of which approximately \$0.3 million was included in Operating Expenses.

No impairment, restructuring, or other charges were recorded during the three months ended October 31, 2007.

**Interest Income**

During the three months ended October 31, 2008, interest income decreased by approximately \$110,000 from \$114,000 during the three months ended October 31, 2007. The decrease for the three months ended October 31, 2008 is mainly due to lower levels of average cash balances during the three months ended October 31, 2008 compared to the three months ended October 31, 2007.

**Interest Expense**

During the three months ended October 31, 2008, interest expense increased to approximately \$3.0 million from approximately \$2.7 million for the three months ended October 31, 2007. The increase of \$0.3 million for the three months ended October 31, 2008 is primarily due to an increased rate of interest and high average outstanding term loan balance during the three months ended October 31, 2008 compared to the three months ended October 31, 2007.

**Loss on debt extinguishment**

During the three months ended October 31, 2007, the Company recorded a loss on debt extinguishment of approximately \$1.7 million in connection with the refinancing of its Amended Credit Agreement completed in September 2007. The total amount of the loss on debt extinguishment consisted of unamortized transaction fees and expenses related to the prior refinancing of the Company's long-term debt in June 2007.

**Other Income (Expense), Net**

Other income (expense), net was approximately \$461,000 during the three months ended October 31, 2008, compared to Other income (expense), net of approximately \$275,000 during the three months ended October 31, 2007. The Other income (expense), net recorded during the three months ended October 31, 2008 is primarily

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attributable to sublease income and gains and losses from our interest rate cap protection related to our long-term debt and a gain of \$0.3 million in foreign currency fluctuation during the three months ended October 31, 2008.

**Income Tax Expense**

The Company recorded \$0.5 million and \$0.4 million of deferred income tax expense during the three months ended October 31, 2008 and 2007, respectively. No income tax benefit was recorded for the losses incurred due to a valuation allowance recognized against deferred tax assets. The deferred tax expense primarily resulted from tax goodwill amortization related to the acquisitions of Surebridge and Alabanza, the acquisition of AppliedTheory Corporation by ClearBlue Technologies Management, Inc. and the carry-over amortization of goodwill resulting from the acquisition of netASPx. Acquired goodwill for these acquisitions is amortizable for tax purposes over fifteen years. For financial statement purposes, goodwill is not amortized but is tested for impairment when evidence of impairment may exist, but at least annually. Tax amortization of goodwill results in a taxable temporary difference, which will not reverse until the goodwill is impaired, written off or the underlying assets are sold by the Company. The resulting taxable temporary difference may not be offset by deductible temporary differences currently available, such as net operating loss carryforwards which expire within a definite period.

**Discontinued Operations**

The discontinued operations relates to the Company's employment services operation called American's Job Exchange ( AJE ). During fiscal year 2008 the Company made the determination that AJE was not core to our business and is actively looking to dispose of this asset.

During the three months ended October 31, 2008 the Company's loss from discontinued operations was \$17,000 as compared to a loss of \$0.3 million for the three months ended October 31, 2007. The loss from discontinued operations decrease during the period was due to increased sales attributed to AJE.

**Liquidity and Capital Resources**

As of October 31, 2008, our principal sources of liquidity included cash and cash equivalents of \$5.0 million and a revolving credit facility of \$10.0 million provided under our Amended Credit Agreement (\$7.0 million available at October 31, 2008). Our current assets, including cash and cash equivalents of \$5.0 million, were approximately \$0.8 million less than current liabilities for the period, giving us a negative working capital position at October 31, 2008.

The total net change in cash and cash equivalents for the three months ended October 31, 2008 was an increase of \$1.8 million. The primary uses of cash during the three months ended October 31, 2008 included \$3.7 million for purchases of property and equipment, approximately \$3.7 million in repayments of notes payable and capital lease obligations, and \$1.2 million in debt issuance costs. Our primary sources of cash during the three months ended October 31, 2008 were \$9.5 million generated from operations and \$0.9 million in borrowings on notes payable.

During fiscal year 2008, the Company entered into a deposit agreement to secure additional data center space in the United Kingdom, totaling \$5.0 million. This deposit was returned during the three months ended October 31, 2008.

Our revolving credit facility with our lending group allows for maximum borrowing of \$10.0 million and expires in June 2012. Outstanding amounts bear interest at either the LIBOR Rate plus 8% or the Base Rate, as defined in the credit agreement, plus 7%, at the Company's option. Interest rates include 2% paid-in-kind ( PIK ) interest until the Consolidated Leverage Ratio, as defined, has been lowered to 3:1. Minimum LIBOR was fixed at 3.15% and LIBOR interest becomes due and is payable quarterly in arrears. At October 31, 2008, the Company had \$3.0 million outstanding on the revolving credit facility.

The Company believes that it has sufficient liquidity to support its operations over the remainder of the fiscal year and for the foreseeable future with its cash resources and committed lines of credit as of October 31, 2008.

**Recent Accounting Pronouncements**

In November 2008, the SEC issued for comment a proposed roadmap regarding the potential use by U.S. issuers of financial statements prepared in accordance with International Financial Reporting Standards ( IFRS ). IFRS is a comprehensive series of accounting standards published by the International Accounting Standards Board ( IASB ). Under the proposed roadmap, we could be required in fiscal 2015 to prepare financial statements in accordance with IFRS, and the SEC will make a determination in 2011 regarding the mandatory adoption of IFRS. We are currently assessing the impact that this potential change would have on our consolidated financial statements, and we will

continue to monitor the development of the potential implementation of IFRS.

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In May 2008, the FASB issued Statement of Financial Accounting Standards No. 162, *The Hierarchy of Generally Accepted Accounting Principles* ( SFAS 162 ), which identifies the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental entities that are presented in conformity with U.S. GAAP. SFAS 162 is effective for the Company 60 days following the SEC's approval of the Public Company Accounting Oversight Board ( PCAOB ) amendments to AU Section 411, *The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles*. The adoption of this Standard is not expected to have a material impact on our results of operations or financial position.

In April 2008, the FASB issued FSP FAS 142-3, *Determination of the Useful Life of Intangible Assets* ( FSP FAS 142-3 ). FSP FAS 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under FASB Statement No. 142, *Goodwill and Other Intangible Asset*. FSP FAS 142-3 is effective for the Company beginning in fiscal 2010. The Company is currently evaluating FSP FAS 142-3 and the impact, if any, that it may have on its results of operations or financial position.

In March 2008, the FASB issued Statement of Financial Accounting Standards No. 161 ( SFAS 161 ), *Disclosures about Derivative Instruments and Hedging Activities* – an amendment of FASB Statement No. 133 . SFAS 161 requires enhanced disclosures about an entity's derivative and hedging activities and thereby improves the transparency of financial reporting. SFAS 161 is effective for fiscal years beginning on or after November 15, 2008. The Company is currently evaluating the impact that the adoption of SFAS 161 will have on its financial position, results of operations and cash flows.

In December 2007, the FASB issued SFAS No. 160, *Non-controlling Interests in Consolidated Financial Statements*, an amendment of ARB NO. 151, ( SFAS 160 ), which requires non-controlling interests (previously referred to as minority interest) to be treated as a separate component of equity, not as a liability as is current practice. SFAS 160 applies to non-controlling interests and transactions with non-controlling interest holders in consolidated financial statements. SFAS 160 is effective for periods beginning on or after December 15, 2008. We are currently evaluating the effect that SFAS 160 will have on our consolidated financial condition and results of operations.

In December 2007, the FASB issued SFAS No. 141(R), *Business Combinations*, ( SFAS 141R ), which requires most identifiable assets, liabilities, non-controlling interests, and goodwill acquired in a business combination to be recorded at full fair value. Under SFAS 141R, all business combinations will be accounted for under the acquisition method. Significant changes, among others, from current guidance resulting from SFAS 141R include the requirement that contingent assets and liabilities and contingent consideration shall be recorded at estimated fair value as of the acquisition date, with any subsequent changes in fair value charged or credited to earnings. Further, acquisition-related costs will be expensed rather than treated as part of the acquisition. SFAS 141R is effective for periods beginning on or after December 15, 2008. The Company is currently evaluating the effect, if any, that SFAS 141R will have on our consolidated financial condition and results of operations.

In February 2007, the FASB issued SFAS No. 159 ( SFAS 159 ), *The Fair Value Option for Financial Assets and Liabilities* . SFAS 159 permits entities to choose to measure many financial instruments and certain other items at fair value. SFAS 159 was adopted by the Company beginning August 1, 2008. The adoption of SFAS 159 did not have a material impact on the Company's consolidated financial position or results of operation.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* ( SFAS 157 ). SFAS 157 defines fair value, establishes a framework for measuring fair value in accordance with generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS 157 was adopted by the Company beginning August 1, 2008. The adoption of SFAS 157 did not have a material impact on the Company's consolidated financial position or results of operation.

**Contractual Obligations and Commercial Commitments**

We are obligated under various capital and operating leases for facilities and equipment. Future minimum annual rental commitments under capital and operating leases and other commitments, as of October 31, 2008, are as follows:

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| <b>Description</b>                         | <b>Total</b>     | <b>Less than<br/>1 Year</b> | <b>1-3 Years<br/>(In thousands)</b> | <b>4-5 Years</b> | <b>After<br/>Year 5</b> |
|--|------------------|-----------------------------|-------------------------------------|------------------|-------------------------|
| Short/Long-term debt                       | \$ 115,412       | \$ 4,792                    | \$ 2,200                            | \$ 108,420       | \$                      |
| Interest on debt <sup>(a)</sup>            | 46,777           | 10,063                      | 20,312                              | 16,402           |                         |
| Capital leases <sup>(a)</sup>              | 25,675           | 5,081                       | 6,068                               | 4,801            | 9,725                   |
| Bandwidth commitments                      | 2,858            | 2,135                       | 723                                 |                  |                         |
| Property leases <sup>(a) (b) (c) (d)</sup> | 81,991           | 11,881                      | 18,456                              | 17,652           | 34,002                  |
| <b>Total</b>                               | <b>\$272,713</b> | <b>\$33,952</b>             | <b>\$47,759</b>                     | <b>\$147,275</b> | <b>\$43,727</b>         |

(a) Interest on debt assumes Libor is fixed at 3.16% and that Company's leverage ratio drops below 3:1 as of January 2010. Based on this the interest rate drops by 2%. Future commitments denominated in foreign currency are fixed at the exchange rate as of October 31, 2008.

(b) Amounts exclude certain common area maintenance and other property charges that are not included within the lease payment.

(c) On February 9, 2005, the Company entered into an Assignment and

Assumption Agreement with a Las Vegas-based company, whereby this company purchased from us the right to use 29,000 square feet in our Las Vegas data center, along with the infrastructure and equipment associated with this space. In exchange, we received an initial payment of \$600,000 and were to receive \$55,682 per month over two years. On May 31, 2006, we received full payment for the remaining unpaid balance. This agreement shifts the responsibility for management of the data center and its employees, along with the maintenance of the facility's infrastructure, to this Las Vegas-based company. Pursuant to this agreement, we have subleased back 2,000 square feet of space, allowing



us to continue servicing our existing customer base in this market. Commitments related to property leases include an amount related to the 2,000 square feet sublease.

- (d) In July 2008, the Company entered into a lease agreement for approximately 11,000 square feet of data center space in the U.K. The Company has not yet accepted delivery of the data center and therefore the future committed property lease amounts are not reflected as of October 31, 2008.

#### **Off-Balance Sheet Financing Arrangements**

The Company does not have any off-balance sheet financing arrangements other than operating leases, which are recorded in accordance with generally accepted accounting principles.

#### **Critical Accounting Policies**

We prepare our consolidated financial statements in accordance with accounting principles generally accepted in the U.S. As such, management is required to make certain estimates, judgments and assumptions that it believes are reasonable based on the information available. These estimates and assumptions affect the reported amounts of assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses for the periods presented. The significant accounting policies which management believes are the most critical to aid in fully understanding and evaluating our reported financial results include revenue recognition, allowance for doubtful accounts, impairment of long-lived assets, goodwill and other intangible assets, stock-based compensation, impairment costs and income taxes. Management reviews its estimates on a regular basis and makes adjustments based on historical experiences, current conditions and future expectations. The reviews are performed regularly and adjustments are made as required by current available information. We believe these estimates are reasonable, but actual results could differ from these estimates.

*Revenue Recognition.* The Company derives its revenue from monthly fees for web site and internet application management and hosting, co-location services and professional services. Reimbursable expenses charged to customers are included in revenue and cost of revenue. Revenue is recognized as services are performed in accordance with all applicable revenue recognition criteria.

Application management, hosting and co-location services are billed and recognized as revenue over the term of the contract, generally one to five years, based on actual customer usage. Installation fees associated with application management, hosting and co-location services are billed at the time the installation service is provided and recognized as revenue over the longer of customer contract or expected term of the related contract. Installation fees generally consist of fees charged to set-up a specific technological environment for a customer within a NaviSite data center. In instances where payment for a service is received in advance of performing those services, the related revenue is deferred until the period in which such services are performed.

Professional services revenue is recognized on a time and materials basis as the services are performed for time and materials type contracts or on a percentage of completion method for fixed price contracts. The Company

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estimates percentage of completion using the ratio of hours incurred on a contract to the projected hours expected to be incurred to complete the contract. Estimates to complete contracts are prepared by project managers and reviewed by management each month. When current contract estimates indicate that a loss is probable, a provision is made for the total anticipated loss in the current period. Contract losses are determined as the amount by which the estimated service costs of the contract exceed the estimated revenue that will be generated by the contract. Historically, our estimates have been consistent with actual results. Unbilled accounts receivable represent revenue for services performed that have not been billed. Billings in excess of revenue recognized are recorded as deferred revenue until the applicable revenue recognition criteria are met.

In accordance with Emerging Issues Task Force (EITF) Issue No. 00-21, *Revenue Arrangements with Multiple Deliverables*, when more than one element such as professional services, installation and hosting services are contained in a single arrangement, the Company allocates revenue between the elements based on acceptable fair value allocation methodologies, provided that each element meets the criteria for treatment as a separate unit of accounting. An item is considered a separate unit of accounting if it has value to the customer on a stand alone basis and there is objective and reliable evidence of the fair value of the undelivered items. The fair value of the undelivered elements is determined by the price charged when the element is sold separately, or in cases when the item is not sold separately, by using other acceptable objective evidence. Management applies judgment to ensure appropriate application of EITF 00-21, including the determination of fair value for multiple deliverables, determination of whether undelivered elements are essential to the functionality of delivered elements, and timing of revenue recognition, among others. For those arrangements where the deliverables do not qualify as a separate unit of accounting, revenue from all deliverables are treated as one accounting unit and generally is recognized ratably over the term of the arrangement.

Existing customers are subject to initial and ongoing credit evaluations based on credit reviews performed by the Company and subsequent to beginning as a customer, payment history and other factors, including the customer's financial condition and general economic trends. If it is determined subsequent to our initial evaluation at any time during the arrangement that collectability is not reasonably assured, revenue is recognized as cash is received as collectability is not considered probable at the time the services are performed.

*Allowance for Doubtful Accounts.* We perform initial and periodic credit evaluations of our customers' financial conditions and generally do not require collateral or other security against trade receivables. We make estimates of the collectability of our accounts receivable and maintain an allowance for doubtful accounts for potential credit losses. We specifically analyze accounts receivable and consider historical bad debts, customer and industry concentrations, customer credit-worthiness (including the customer's financial performance and their business history), current economic trends and changes in our customers' payment patterns when evaluating the adequacy of the allowance for doubtful accounts. We specifically reserve for 100% of the balance of customer accounts deemed uncollectible. For all other customer accounts, we reserve for 20% of the balance over 90 days old (based on invoice date) and 1% - 2% of all other customer balances. Historically, the Company's estimates have been consistent with actual results. Changes in economic conditions or the financial viability of our customers may result in additional provisions for doubtful accounts in excess of our current estimate. A 5% to 10% unfavorable change in our provision requirements would result in an approximate \$50,000 to \$100,000 decrease to income from continuing operations.

*Impairment of Long-lived Assets and Goodwill and Other Intangible Assets.* We review our long-lived assets, subject to amortization and depreciation, for impairment whenever events or changes in circumstances indicate that the carrying amount of these assets may not be recoverable. Long-lived and other intangible assets include customer lists, customer contract backlog, developed technology, vendor contracts, trademarks, non-compete agreements and property and equipment. Factors we consider important that could trigger an impairment review include:

significant underperformance relative to expected historical or projected future operating results;

significant changes in the manner of our use of the acquired assets or the strategy of our overall business;

significant negative industry or economic trends;

significant declines in our stock price for a sustained period; and

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our market capitalization relative to net book value.

Recoverability is measured by a comparison of the carrying amount of an asset to the future undiscounted cash flows expected to be generated by the asset. If the undiscounted cash flows expected to be generated by the use and disposal of the asset are less than its carrying value, and therefore, impaired, the impairment loss recognized would be measured by the amount by which the carrying value of the assets exceeds its fair value. Fair value is determined based on discounted cash flows or values determined by reference to third party valuation reports, depending on the nature of the asset. Assets to be disposed of are valued at the lower of the carrying amount or their fair value less disposal costs. Property and equipment is primarily comprised of leasehold improvements, computer and office equipment and software licenses.

We review the valuation of our goodwill in the fourth quarter of each fiscal year, or on an interim basis, if it is considered more likely than not that an impairment loss has been incurred. The Company's valuation methodology for assessing impairment requires management to make judgments and assumptions based on historical experience and to rely heavily on projections of future operating performance. The Company operates in highly competitive environments and projections of future operating results and cash flows may vary significantly from actual results. If our assumptions used in preparing our estimates of the Company's reporting unit(s) projected performance for purposes of impairment testing differ materially from actual future results, the Company may record impairment changes in the future and our operating results may be adversely affected. The Company completed its annual impairment review of goodwill as of July 31, 2008 and concluded that goodwill was not impaired. No impairment indicators have arisen since that date to cause us to perform an impairment assessment since that date. At October 31, 2008 and July 31, 2008, the carrying value of goodwill and other intangible assets totaled \$94.0 million and \$96.0 million, respectively.

*Stock-Based Compensation Plans*

On August 1, 2005, the first day of the Company's fiscal year 2006, the Company adopted the provisions of SFAS No. 123(R), *Share-Based Payment* which requires the measurement and recognition of compensation expense for all stock-based payment awards made to employees and directors including employee stock options and employee stock purchases based on estimated fair values. In March 2005, the SEC issued Staff Accounting Bulletin (SAB) No. 107 relating to SFAS No. 123(R). The Company has applied the provisions of SAB No. 107 in its adoption of SFAS No. 123(R).

SFAS No. 123(R) requires companies to estimate the fair value of stock-based payment awards on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as expense over the requisite service periods in the Company's consolidated statement of operations. SFAS No. 123(R) supersedes the Company's previous accounting under the provisions of SFAS No. 123, *Accounting for Stock-Based Compensation*. As permitted by SFAS No. 123, the Company measured options, granted prior to August 1, 2005, as compensation cost in accordance with Accounting Principles Board Opinion (APB) No. 25, *Accounting for Stock Issued to Employees* and related interpretations. Accordingly, no accounting recognition is given to stock options granted at fair market value until they are exercised. Upon exercise, net proceeds, including tax benefits realized, were credited to equity.

The Company adopted SFAS No. 123(R) using the modified prospective transition method, which requires the application of the accounting standard as of August 1, 2005. In accordance with the modified prospective transition method, the Company's consolidated financial statements for prior periods have not been restated to reflect, and do not include, the impact of SFAS No. 123(R).

Stock-based compensation expense recognized during the period is based on the value of the portion of stock-based payment awards that is ultimately expected to vest during the period, reduced for estimated forfeitures. SFAS No. 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. In the Company's pro forma information required under SFAS No. 123 for the periods prior to August 1, 2005, the Company established estimates for forfeitures. Stock-based compensation expense recognized in the Company's consolidated statements of operations for the three month periods ended October 31, 2008 and 2007 included compensation expense for stock-based payment awards granted prior to, but not yet vested as of July 31, 2005 based on the grant date fair value estimated in accordance with the pro forma provisions



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subsequent to July 31, 2005 based on the grant date fair value estimated in accordance with the provisions of SFAS No. 123(R).

In accordance with SFAS No. 123(R), the Company uses the Black-Scholes option-pricing model ( Black-Scholes model ). In utilizing the Black-Scholes model, the Company is required to make certain estimates in order to determine the grant-date fair value of equity awards. These estimates can be complex and subjective and include the expected volatility of the Company's common stock, our dividend rate, a risk-free interest rate, the expected term of the equity award and the expected forfeiture rate of the equity award. Any changes in these assumptions may materially affect the estimated fair value of our recorded stock-based compensation.

*Impairment costs.* The Company generally records impairments related to underutilized real estate leases. Generally, when it is determined that a facility will no longer be utilized and the facility will generate no future economic benefit, an impairment loss will be recorded in the period such determination is made. As of October 31, 2008, the Company's accrued lease impairment balance totaled approximately \$1.0 million, all of which represents amounts that are committed under remaining contractual obligations. These contractual obligations principally represent future obligations under non-cancelable real estate leases. Impairment estimates relating to real estate leases involve consideration of a number of factors including: potential sublet rental rates, estimated vacancy period for the property, brokerage commissions and certain other costs. Estimates relating to potential sublet rates and expected vacancy periods are most likely to have a material impact on the Company's results of operations in the event that actual amounts differ significantly from estimates. These estimates involve judgment and uncertainties, and the settlement of these liabilities could differ materially from recorded amounts. As such, in the course of making such estimates, management often uses third party real estate professionals to assist management in its assessment of the marketplace for purposes of estimating sublet rates and vacancy periods. Historically, the Company's estimates have been consistent with actual results. A 10% - 20% unfavorable settlement of our remaining liabilities for impaired facilities, as compared to our current estimates, would decrease our income from continuing operations by approximately \$0.1 million to \$0.2 million.

*Income Taxes.* Income taxes are accounted for under the provisions of SFAS No. 109, Accounting for Income Taxes, using the asset and liability method whereby deferred tax assets and liabilities are recognized for the estimated future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates in effect for the year in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. SFAS No. 109 also requires that the deferred tax assets be reduced by a valuation allowance, if based on the weight of available evidence, it is more likely than not that some portion or all of the recorded deferred tax assets will not be realized in future periods. This methodology is subjective and requires significant estimates and judgments in the determination of the recoverability of deferred tax assets and in the calculation of certain tax liabilities. At October 31, 2008 and 2007, respectively, a valuation allowance has been recorded against the gross deferred tax asset since management believes that after considering all the available objective evidence, both positive and negative, historical and prospective, with greater weight given to historical evidence, it is more likely than not that these assets will not be realized. In each reporting period, we evaluate the adequacy of our valuation allowance on our deferred tax assets. In the future, if the Company is able to demonstrate a consistent trend of pre-tax income then, at that time, management may reduce its valuation allowance accordingly. The Company's federal, state and foreign net operating loss carryforwards at October 31, 2008 totaled \$179.7 million, \$179.7 million and \$2.0 million, respectively. A 5% reduction in the Company's current valuation allowance on these federal and state net operating loss carryforwards would result in an income tax benefit of approximately \$4.9 million for the reporting period.

In addition, the calculation of the Company's tax liabilities involves dealing with uncertainties in the application of complex tax regulations in several tax jurisdictions. The Company is periodically reviewed by domestic and foreign tax authorities regarding the amount of taxes due. These reviews include questions regarding the timing and amount of deductions and the allocation of income among various tax jurisdictions. In evaluating the exposure associated with various filing positions, we record estimated reserves for probable exposures. Based on our evaluation of current tax positions, the Company believes it has appropriately accrued for exposures.

**Item 3. Quantitative and Qualitative Disclosures About Market Risk**

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We do not enter into financial instruments for trading purposes. We have not used derivative financial instruments or derivative commodity instruments in our investment portfolio or entered into hedging transactions. However, under our senior secured credit facility, we are required to maintain interest rate protection which shall effectively limit the unadjusted variable component of the interest costs of our facility with respect to not less than 50% of the principal amount of all Indebtedness, as defined, at a rate that is acceptable to the lending group's agent. Our exposure to market risk associated with risk-sensitive instruments entered into for purposes other than trading purposes is not material. Our interest rate risk at October 31, 2008 was limited mainly to LIBOR on our outstanding term loans under our senior secured credit facility. At October 31, 2008 we had no open derivative positions with respect to our borrowing arrangements. A hypothetical 100 basis point increase in the LIBOR rate would have resulted in an approximate \$0.3 million increase in our interest expense under our senior secured credit facility for the fiscal quarter ended October 31, 2008.

**Item 4. Controls and Procedures**

***Disclosure Controls and Procedures.*** Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures (as defined in Rule 13a-15(e) of the Securities Exchange Act of 1934) as of the end of the period covered by this report. Based on that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures as of the end of the period covered by this report were effective in ensuring that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

***Internal Control Over Financial Reporting.*** There was no change in our internal control over financial reporting (as defined in Rule 13a-15(f) of the Securities Exchange Act of 1934) that occurred during the fiscal quarter to which this report relates that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

**PART II: OTHER INFORMATION****Item 1. Legal Proceedings*****IPO Securities Litigation***

In 2001, lawsuits naming more than 300 issuers and over 50 investment banks were filed in the United States District Court for the Southern District of New York and assigned to the Honorable Shira A. Scheindlin (the "Court") for all pretrial purposes (the "IPO Securities Litigation"). Between June 13, 2001 and July 10, 2001 five purported class action lawsuits seeking monetary damages were filed against us, Joel B. Rosen, our then chief executive officer, Kenneth W. Hale, our then chief financial officer, Robert E. Eisenberg, our then president, and the underwriters of our initial public offering of October 22, 1999. On September 6, 2001, the Court consolidated the five similar cases and a consolidated, amended complaint was filed on April 19, 2002 (the "Class Action Litigation") against us and Messrs. Rosen, Hale and Eisenberg (collectively, the "NaviSite Defendants") and against underwriter defendants Robertson Stephens (as successor-in-interest to BancBoston), BancBoston, J.P. Morgan (as successor-in-interest to Hambrecht & Quist), Hambrecht & Quist and First Albany. The plaintiffs uniformly alleged that all defendants, including the NaviSite Defendants, violated Sections 11 and 15 of the Securities Act of 1933, Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5 by issuing and selling our common stock in the offering, without disclosing to investors that some of the underwriters, including the lead underwriters, allegedly had solicited and received undisclosed agreements from certain investors to purchase aftermarket shares at pre-arranged, escalating prices and also to receive additional commissions and/or other compensation from those investors. The Class Action Litigation seeks certification of a plaintiff class consisting of all persons who acquired shares of our common stock between October 22, 1999 and December 6, 2000. The claims against Messrs. Rosen, Hale and Eisenberg were dismissed without prejudice on November 18, 2002, in return for their agreement to toll any statute of limitations applicable to those claims. At this time, plaintiffs have not specified the amount of damages they are seeking in the Class Action Litigation. On October 13, 2004, the Court certified a class in a sub-group of cases (the "Focus Cases") in the IPO Securities Litigation, which was vacated on December 5, 2006 by the



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United States Court of Appeals for the Second Circuit (the Second Circuit). The Class Action Litigation is not one of the Focus Cases. Plaintiffs-appellees January 5, 2007 petition with the Second Circuit for rehearing and rehearing en banc was denied by the Second Circuit on April 6, 2007. Plaintiffs renewed their certification motion in the Focus Cases on September 27, 2007 as to redefined classes pursuant to Fed. R. Civ. P. 23(b)(3) and 23(c)(4). On October 3, 2008, after briefing, in connection with the renewed class certification proceedings was completed, plaintiffs withdrew without prejudice the renewed certification motion in the Focus Cases. On October 10, 2008, the Court confirmed plaintiffs request and directed the clerk to close the renewed certification motion. Additionally, on August 14, 2007, plaintiffs filed amended class action complaints in the Focus Cases, along with an accompanying set of Amended Master Allegations (collectively, the Amended Complaints). Plaintiffs therein (i) revise their allegations with respect to (1) the issue of investor knowledge of the alleged undisclosed agreements with the underwriter defendants and (2) the issue of loss causation; (ii) include new pleadings concerning alleged governmental investigations of certain underwriters; and (iii) add additional plaintiffs to certain of the Amended Complaints. On March 26, 2008, the Court entered an order granting in part and denying in part the motions to dismiss filed by the defendants named in the Focus Cases. Specifically, the Court dismissed the Section 11 claims brought by plaintiffs (1) who lacked recoverable Section 11 damages and (2) whose claims were time barred, but otherwise denied the motions as to the other claims alleged in the Amended Complaints.

On October 12, 2007, a purported shareholder of the Company filed a complaint for violation of Section 16(b) of the Securities Exchange Act of 1934, which prohibits short-swing trading, against two of the underwriters of the public offering at issue in the Class Action Litigation. The complaint is pending in the United States District Court for the Western District of Washington and is captioned Vanessa Simmonds v. Bank of America Corp., et al. An amended complaint was filed on February 28, 2008. Plaintiff seeks the recovery of short-swing profits from the underwriters on behalf of the Company, which is named only as a nominal defendant and from whom no recovery is sought. Similar complaints have been filed against the underwriters of the public offerings of approximately 55 other issuers also involved in the IPO Securities Litigation. A joint status conference was held on April 28, 2008, at which the Court stayed discovery and ordered the parties to file motions to dismiss by July 25, 2008. On July 25, 2008, the Company joined 29 other nominal defendant issuers and filed Issuer Defendants Joint Motion to Dismiss the Amended Complaint. On the same date, the Underwriter Defendants also filed a Joint Motion to Dismiss. On September 8, 2008, plaintiff filed her oppositions to the motions. The replies in support of the motions to dismiss were filed on October 23, 2008. Oral arguments on all motions to dismiss are scheduled for January 16, 2009.

We believe that the allegations against us are without merit and we intend to vigorously defend against the plaintiffs claims. Due to the inherent uncertainty of litigation, we are not able to predict the possible outcome of the suits and their ultimate effect, if any, on our business, financial condition, results of operations or cash flows.

***Other litigation***

In October 2007, the Company, pursuant to its integration plans, closed the former Alabanza data center in Baltimore, Maryland and moved all equipment to the Company's data center in Andover, Massachusetts (the Data Migration). In connection with the Data Migration, the Company encountered unforeseen circumstances which led to extended down-time for certain of its customers.

On November 14, 2007, Pam Kagan Marketing, Inc., d/b/a Earthplaza, filed a complaint in the United States District Court for the District of Maryland (the Court) against the Company and Alabanza Corporation seeking a class status for the customers who experienced web hosting service interruptions as a result of the Data Migration (the November Class Action Litigation). The total damages claimed approximate \$5.0 million. On January 4, 2008, Palmatec, LLC, NYC Merchandise and Taglogic RFID, Ltd. filed a complaint in the Maryland State Court, Circuit Court for Baltimore against the Company seeking a class status for the direct customers (the Direct Subclass) and the entities that purchased hosting services from those direct customers (the Non-Privy Subclass) (the January Class Action Litigation). The total damages claimed approximate \$10.0 million. The January Class Action Litigation was removed to the Court by the Company. On May 11, 2008, the Court issued an order consolidating the two cases. On August 5, 2008, the plaintiffs in the January Class Action Litigation voluntarily withdrew their case, without prejudice, because of the inadequacy of their class representative. The claims of the Direct Subclass continue to be litigated in the November Class Action Litigation. The Company believes that the potential plaintiffs in the combined

class action may be denied class status and further, that the plaintiffs' claims are without merit. The Company plans to defend itself vigorously; however, at this time, due to the inherent uncertainty of litigation, we are not able to predict the possible outcome of the suit and its ultimate effect, if any, on our business, financial condition, results of operations or cash flows.

**Table of Contents****Item 1A. Risk Factors**

Other than with respect to the risk factor below, there have been no material changes to the risk factors disclosed in Part I, Item 1A. Risk Factors in our Annual Report on Form 10-K for the fiscal year ended July 31, 2008. The risks described below and in our Annual Report on Form 10-K are not the only risks we face. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results.

***Our common stock may be delisted from the Nasdaq Stock Market.*** On November 6, 2008, the Company was notified by the Nasdaq Listings Qualification Staff (the Staff) that it was not in compliance with the Nasdaq Marketplace Rule 4310(c)(3) (the Rule), which requires that the Company maintain: (i) stockholders' equity of \$2.5 million; (ii) market value of listed securities of \$35 million; or (iii) net income from continuing operations of \$500,000 in the most recently completed fiscal year or in two of the last three most recently completed fiscal years. On November 21, 2008, the Company responded to the Staff summarizing the Company's plan to achieve and sustain compliance with all Nasdaq Capital Market listing requirements. On December 12, 2008, the Staff granted the Company an extension to February 19, 2009 to regain compliance with the Rule. The initial deficiency notification from the Staff has no effect on the listing of our common stock at this time. There is no assurance that we will regain compliance with Nasdaq Marketplace Rule 4310(c)(3) and our common stock may ultimately be delisted from the Nasdaq Capital Market.

In addition, Nasdaq's continued listing standards for our common stock require, among other things, that we maintain a closing bid price for our common stock of at least \$1.00. Our common stock recently has closed with a bid price of less than \$1.00. However, on October 16, 2008, Nasdaq announced that it had temporarily suspended its minimum bid price and market value of public float requirements for continued listing through January 16, 2009. Nasdaq adopted this measure to help companies remain listed in view of the extraordinary market conditions following the recent turmoil in the global economy and stock markets. Under the temporary relief provided by the new rules, companies will not be cited for bid price or market value of public float deficiencies.

If our common stock were delisted from Nasdaq, among other things, this could result in a number of negative implications, including reduced liquidity in our common stock as a result of the loss of market efficiencies associated with Nasdaq and the loss of federal preemption of state securities laws as well as the potential loss of confidence by suppliers, customers and employees, the loss of analyst coverage and institutional investor interest, fewer business development opportunities, greater difficulty in obtaining financing and breaches of certain contractual obligations.

In the event that the Company receives notice that its common stock is being delisted from the Nasdaq Stock Market, Nasdaq rules permit the Company to appeal any delisting determination by the Staff to a Nasdaq Listings Qualifications Panel.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

On September 12, 2007, the Company acquired the outstanding capital stock of netASPx, an application management service provider, for total consideration of \$40.8 million. The consideration consisted of \$15.5 million in cash, subject to adjustment based on netASPx's cash at the closing date, and the issuance of 3,125,000 shares of the Preferred Stock of the Company with a fair value of \$24.9 million at the time of issuance. The Preferred Stock accrues payment-in-kind (PIK) dividends at 8% per annum, payable quarterly, increasing to 10% per annum in September 2008 and 12% per annum in March 2009.

Pursuant to the obligation described above, on December 15, 2008, the Company issued a PIK dividend of an aggregate of 84,657.13 shares of the Preferred Stock to its holders of Preferred Stock.

The shares issued as described in this Item 2 were not registered under the Securities Act of 1933, as amended (the Securities Act). The Company relied on the exemption from registration provided by Section 4(2) of the Securities Act as an issuance by the Company not involving a public offering. No underwriters were involved with the issuance of the Preferred Stock.

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**Item 5. Other Information**

During the quarter ended October 31, 2008, we made no material changes to the procedures by which stockholders may recommend nominees to our Board of Directors, as described in our most recent proxy statement.

**Item 6. Exhibits**

The Exhibits listed in the Exhibit Index immediately preceding such Exhibits are filed with, or incorporated by reference in, this report.

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SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

December 17, 2008

NAVISITE, INC.

By: /s/ James W. Pluntze

James W. Pluntze  
(Principal Financial and Accounting  
Officer)

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**EXHIBIT INDEX**

| <b>Exhibit Number</b> | <b>Description</b>   |
|-----------------------|--|
| 10.1                  | Amendment No. 1 to Separation Agreement dated as of December 4, 2008, by and between the Registrant and Arthur Becker is incorporated herein by reference to Exhibit 10.1 to the Registrant's Current Report on Form 8-K dated December 9, 2008 (File No. 000-27597).    |
| 10.2                  | Amendment No. 1 to Separation Agreement dated as of December 4, 2008, by and between the Registrant and James W. Pluntze is incorporated herein by reference to Exhibit 10.2 to the Registrant's Current Report on Form 8-K dated December 9, 2008 (File No. 000-27597). |
| 10.3                  | Amendment No. 1 to Separation Agreement dated as of December 7, 2008, by and between the Registrant and Mark Clayman is incorporated herein by reference to Exhibit 10.3 to the Registrant's Current Report on Form 8-K dated December 9, 2008 (File No. 000-27597).     |
| 10.4                  | Amendment No. 5 to Lease dated August 15, 2008, by and between 400 Minuteman LLC and the Registrant.   |
| 31.1                  | Certification of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.  |
| 31.2                  | Certification of the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.  |
| 32.1                  | Certification of the Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.   |
| 32.2                  | Certification of the Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.   |