

NAVISITE INC  
Form 10-Q  
March 15, 2007

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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 January 31, 2007**

**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, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act.

Large accelerated filer  Accelerated filer  Non-accelerated filer

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 March 9, 2007, there were 31,080,480 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 JANUARY 31, 2007**

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

|  | <b>January 31,<br/>2007</b> | <b>July 31,<br/>2006</b> |
|--|-----------------------------|--------------------------|
| <b>ASSETS</b>  |                             |                          |
| Current assets:  |                             |                          |
| Cash and cash equivalents  | \$ 2,975                    | \$ 3,360                 |
| Accounts receivable, less allowance for doubtful accounts of \$1,368 and \$1,944 at January 31, 2007 and July 31, 2006, respectively | 12,851                      | 11,872                   |
| Unbilled accounts receivable   | 789                         | 430                      |
| Due from related party   |                             | 30                       |
| Prepaid expenses and other current assets  | 9,747                       | 8,804                    |
| <br>   |                             |                          |
| Total current assets   | 26,362                      | 24,496                   |
| Property and equipment, net  | 14,383                      | 14,914                   |
| Customer lists, less accumulated amortization of \$20,192 and \$18,104 at January 31, 2007 and July 31, 2006, respectively           | 9,599                       | 11,687                   |
| Goodwill   | 43,159                      | 43,159                   |
| Other assets   | 6,348                       | 7,214                    |
| Restricted cash  | 930                         | 939                      |
| <br>   |                             |                          |
| Total assets   | \$ 100,781                  | \$ 102,409               |
| <br>   |                             |                          |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY (DEFICIT)</b>   |                             |                          |
| Current liabilities:   |                             |                          |
| Notes payable, current portion   | \$ 4,825                    | \$ 2,115                 |
| Notes payable to the AppliedTheory Estate  | 6,000                       | 6,000                    |
| Capital lease obligations, current portion   | 2,272                       | 2,081                    |
| Accounts payable   | 5,345                       | 5,338                    |
| Accrued expenses and other current liabilities   | 13,020                      | 13,732                   |
| Deferred revenue, deferred other income and customer deposits  | 4,318                       | 4,302                    |
| <br>   |                             |                          |
| Total current liabilities  | 35,780                      | 33,568                   |
| Capital lease obligations, less current portion  | 573                         | 741                      |
| Accrued lease abandonment costs, less current portion  | 1,017                       | 1,628                    |
| Deferred tax liability   | 3,099                       | 2,512                    |
| Other long-term liabilities  | 2,713                       | 3,258                    |
| Note payable, less current portion   | 59,274                      | 59,678                   |
| Note payable to related party  |                             | 3,000                    |
| <br>   |                             |                          |
| Total liabilities  | 102,456                     | 104,385                  |
| <br>   |                             |                          |
| Commitments and contingencies (Note 10)  |                             |                          |

Stockholders' equity (deficit):

Preferred stock, \$0.01 par value; Authorized 5,000 shares; Issued and outstanding: no shares at January 31, 2007 and July 31, 2006

Common stock, \$0.01 par value; Authorized 395,000 shares; Issued and outstanding: 31,042 at January 31, 2007 and 28,959 at July 31, 2006

Accumulated other comprehensive income

Additional paid-in capital

Accumulated deficit

|           |           |
|-----------|-----------|
| 310       | 290       |
| 242       | 203       |
| 474,101   | 467,400   |
| (476,328) | (469,869) |

Total stockholders' equity (deficit)

|         |         |
|---------|---------|
| (1,675) | (1,976) |
|---------|---------|

Total liabilities and stockholders' equity (deficit)

|            |            |
|------------|------------|
| \$ 100,781 | \$ 102,409 |
|------------|------------|

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>Six Months Ended</b> |                |
|--|---------------------------|----------------|-------------------------|----------------|
|  | <b>January</b>            | <b>January</b> | <b>January</b>          | <b>January</b> |
|  | <b>31,</b>                | <b>31,</b>     | <b>31,</b>              | <b>31,</b>     |
|  | <b>2007</b>               | <b>2006</b>    | <b>2007</b>             | <b>2006</b>    |
| Revenue  | \$ 30,115                 | \$ 26,264      | \$ 58,561               | \$ 51,674      |
| Revenue, related parties   | 82                        | 41             | 176                     | 71             |
| Total revenue  | 30,197                    | 26,305         | 58,737                  | 51,745         |
| Cost of revenue  | 20,546                    | 18,693         | 39,789                  | 36,370         |
| Total cost of revenue  | 20,546                    | 18,693         | 39,789                  | 36,370         |
| Gross profit   | 9,651                     | 7,612          | 18,948                  | 15,375         |
| Operating expenses:  |                           |                |                         |                |
| Selling and marketing  | 4,222                     | 3,955          | 7,855                   | 7,204          |
| General and administrative   | 5,857                     | 5,095          | 11,154                  | 10,980         |
| Impairment, restructuring and other                                    |                           | 377            | (287)                   | 377            |
| Total operating expenses   | 10,079                    | 9,427          | 18,722                  | 18,561         |
| Income (Loss) from operations  | (428)                     | (1,815)        | 226                     | (3,186)        |
| Other income (expense):  |                           |                |                         |                |
| Interest income  | 42                        | 26             | 84                      | 54             |
| Interest expense   | (3,190)                   | (2,015)        | (6,428)                 | (3,992)        |
| Other income (expense), net  | 54                        | 130            | 246                     | 273            |
| Loss before income tax expense   | (3,522)                   | (3,674)        | (5,872)                 | (6,851)        |
| Income tax expense   | (294)                     | (294)          | (587)                   | (587)          |
| Net loss   | \$ (3,816)                | \$ (3,968)     | \$ (6,459)              | \$ (7,438)     |
| Basic and diluted net loss per common share                            | \$ (0.13)                 | \$ (0.14)      | \$ (0.22)               | \$ (0.26)      |
| Basic and diluted weighted average number of common shares outstanding | 29,714                    | 28,481         | 29,376                  | 28,481         |

See accompanying notes to condensed consolidated financial statements.



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

|  | <b>Six Months Ended</b>         |                             |
|--|---------------------------------|-----------------------------|
|  | <b>January<br/>31,<br/>2007</b> | <b>January 31,<br/>2006</b> |
| Cash flows from operating activities:  |                                 |                             |
| Net loss   | \$ (6,459)                      | \$ (7,438)                  |
| Adjustments to reconcile net loss to net cash provided by (used for) operating activities: |                                 |                             |
| Depreciation and amortization  | 6,787                           | 6,251                       |
| Mark to market for interest rate cap   | 139                             |                             |
| Costs (recoveries) associated with abandoned leases  | (287)                           | 377                         |
| Amortization of warrants   | 1,017                           | 53                          |
| Stock based compensation   | 1,834                           | 2,120                       |
| Provision for bad debts  | (53)                            | 365                         |
| Deferred income tax expense  | 587                             | 587                         |
| Changes in operating assets and liabilities:   |                                 |                             |
| Accounts receivable  | (926)                           | (1,760)                     |
| Unbilled accounts receivable   | (359)                           | (69)                        |
| Due from related party   | 30                              | 27                          |
| Prepaid expenses and other current assets, net   | (931)                           | (300)                       |
| Long term assets   | 727                             | (1)                         |
| Accounts payable   | 8                               | (462)                       |
| Long-term liabilities  | 1,493                           | (32)                        |
| Accrued expenses, deferred revenue and customer deposits                                   | (1,001)                         | (222)                       |
| Net cash provided by (used for) operating activities                                       | 2,606                           | (504)                       |
| Cash flows from investing activities:  |                                 |                             |
| Purchase of property and equipment   | (2,942)                         | (2,298)                     |
| Net cash used for investing activities   | (2,942)                         | (2,298)                     |
| Cash flows from financing activities:  |                                 |                             |
| Restricted cash  | (1)                             |                             |
| Proceeds from exercise of stock options and warrants                                       | 1,023                           |                             |
| Proceeds from notes payable  | 1,754                           | 436                         |
| Repayment of notes payable   | (639)                           | (1,610)                     |
| Payments on capital lease obligations  | (2,186)                         | (940)                       |
| Net cash used for financing activities   | (49)                            | (2,114)                     |
| Net decrease in cash   | (385)                           | (4,916)                     |
| Cash and cash equivalents, beginning of period   | 3,360                           | 6,816                       |



|  |          |          |
|--|----------|----------|
| Cash and cash equivalents, end of period                               | \$ 2,975 | \$ 1,900 |
| Supplemental disclosure of cash flow information:                      |          |          |
| Cash paid for interest   | \$ 4,135 | \$ 2,248 |
| See accompanying notes to condensed consolidated financial statements. |          |          |

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

**(1) Description of Business**

NaviSite, Inc. ( NaviSite , the Company , we , us or our ) provides information technology (IT) hosting, outsourcing and professional services for mid- to large-sized 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 clients' business. Over 950 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. NaviSite has 14 state-of-the-art data centers and 8 major office locations across the U.S., U.K. and 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 NaviSite, Inc. 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 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 October 26, 2006. 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 and six months ended January 31, 2007 are not necessarily indicative of the results expected for the remainder of the fiscal year ending July 31, 2007.

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

The preparation of financial statements in conformity with U.S. generally accepted accounting principles 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, recoverability of long-lived assets, the collectability of receivables, revenue recognition, and other assumptions for sublease and lease abandonment reserves.

**(b) Revenue Recognition**

Revenue consists primarily of monthly fees for Web site and Internet custom and packaged application management, hosting, colocation and professional services. The Company also derives revenue from the sale of software and related maintenance contracts. Reimbursable expenses charged to clients are included in revenue and cost of revenue. Application management, hosting and colocation revenue (other than installation fees) is billed and recognized over the term of the contract, generally one to three years, based on actual usage. Payments received in advance of providing services are deferred until the period such services are provided. Revenue from professional services is recognized on either a time and material basis as the services are performed or under the percentage of completion method for fixed-price contracts. We generally sell our professional services under contracts with terms ranging from one to five years. 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 costs of the contract exceed the estimated revenue that will be generated by the contract. Unbilled accounts receivable represents 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. Revenue from the sale of software is recognized when persuasive evidence of an arrangement exists, the product has been delivered, the fees are fixed and determinable and collection of the resulting receivable is reasonably assured.



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

In instances where the Company also provides application management and hosting services in conjunction with the sale of software, software revenue is deferred and recognized ratably over the expected customer relationship period. If we determine that collection of a fee is not reasonably assured, we defer the fee and recognize revenue at the time collection becomes reasonably assured, which is generally upon receipt of cash.

**(c) 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 \$7.4 million as of January 31, 2007 and July 31, 2006, including \$6.5 million which is classified as short-term on the Condensed Consolidated Balance Sheets as of January 31, 2007 and July 31, 2006, respectively and is included in Prepaid expenses and other current assets. The January 31, 2007 and July 31, 2006 balances primarily represent cash held in escrow for payment to the AppliedTheory Estate against the Note Payable and cash collateral requirements for standby letters of credit associated with several of the Company's facility and equipment leases.

**(d) 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 are amortized using the straight-line method over the shorter of the lease term or estimated useful life of the asset. Assets acquired under capital leases in which title transfers to us at the end of the agreement are amortized over the useful life of the asset. 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 Consolidated Statements of Operations.

**(e) 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. This statement 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 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 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 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 an impairment loss has been incurred. An impairment loss shall be recognized to the extent that the carrying amount of goodwill exceeds its implied fair value. Impairment losses shall be 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 impairment charges in the future.

**(f) Concentration of Credit Risk**

Our financial instruments include cash, accounts receivable, obligations under capital leases, debt agreements, derivative instruments, accounts payable, and accrued expenses. As of January 31, 2007, the carrying cost of these

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

instruments approximated their fair value. The financial instruments that potentially subject us to concentration of credit risk consist primarily of accounts receivable. Concentration of credit risk with respect to trade receivables is limited due to the large number of customers across many industries that comprise our customer base. One third-party customer accounted for 8% of our total revenue for the six months ended January 31, 2007 and 2006, respectively. Accounts receivable include approximately \$0.9 million due from this third-party customer at January 31, 2007 and approximately \$0.9 million at July 31, 2006.

**(g) 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 reports accumulated other comprehensive income (loss), resulting from foreign currency translation adjustment, on the Condensed Consolidated Balance Sheets.

**(h) 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.

**(i) Stock Based Compensation**

In December 2004, the Financial Accounting Standards Board (FASB) issued a Statement, Share-Based Payment, an amendment of FASB Statements Nos. 123 and 95 (SFAS 123R), that addresses the accounting for share-based payment transactions in which a company receives employee services in exchange for either equity instruments of the company or liabilities that are based on the fair value of the company's equity instruments or that may be settled by the issuance of such equity instruments. The statement eliminates the ability to account for share-based compensation transactions using the intrinsic value method and generally requires that such transactions be accounted for using a fair value based method and recognized as expense in the Consolidated Statement of Operations. In March 2005, the SEC issued Staff Accounting Bulletin (SAB) No. 107 regarding the Staff's interpretation of SFAS 123R. This interpretation provides the Staff's views regarding interpretations between SFAS 123R and certain SEC rules and regulations and provides interpretations of the valuation of share-based payments for public companies. The interpretive guidance is intended to assist companies in applying the provisions of SFAS 123R and investors and users of financial statements in analyzing the information provided.

Following the guidance prescribed in SAB 107, on August 1, 2005, NaviSite adopted SFAS 123R using the modified prospective method, and accordingly, we have not restated the consolidated results of income from prior interim periods and fiscal years. Under SFAS 123R, we are required to measure compensation cost for all stock based awards at fair value on date of grant and recognize compensation expense over the service period that the awards are expected to vest. For US and UK grants, the Company generally grants options under its equity plan that vest as to 25% of the original number of shares on the sixth month (180 days) following the date of the grant and thereafter in equal monthly amounts over the three year period commencing on the sixth month (180 days) following the date of grant. In February 2006, the Company issued its first option grants to its India employees. The options vested as to 33.33% of the original number of shares on the ninth month (270 days) following the date of the grant and thereafter in equal monthly amounts over the three year period commencing on the ninth month (270 days) following the date of grant. In October 2006, the Company eliminated this deviation from the US Plan and made the India Plan consistent with the US Plan.

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

The Company uses the Black-Scholes option pricing model to value the compensation expense associated with the stock based awards under SFAS123R. The following table reflects the stock compensation expense for the Company for the three and six months ended January 31, 2007 and 2006.

|                          | <b>Three Months Ended</b> |             | <b>Six Months Ended</b> |             |
|--------------------------|---------------------------|-------------|-------------------------|-------------|
|                          | <b>January 31,</b>        |             | <b>January 31,</b>      |             |
|                          | <b>(in thousands)</b>     |             | <b>(in thousands)</b>   |             |
|                          | <b>2007</b>               | <b>2006</b> | <b>2007</b>             | <b>2006</b> |
| Cost of Sales            | \$282                     | \$244       | \$ 523                  | \$ 494      |
| Sales & Marketing        | \$113                     | \$ 86       | \$ 201                  | \$ 165      |
| General & Administrative | \$610                     | \$703       | \$1,110                 | \$1,461     |

The fair value of each stock option grant was estimated on the date of grant assuming no expected dividends and the following weighted average assumptions. The expected volatility is based upon the historical volatility of the Company's stock price. The expected term is the period of time between the date the option is granted and the date the option is fully exercisable. The period of time takes into consideration the vesting period of the option, the average period of time similar options have remained outstanding in the past, and events that might influence exercise behavior (such as stock price volatility).

|  | <b>Three Months Ended</b> |             | <b>Six Months Ended</b> |             |
|--|---------------------------|-------------|-------------------------|-------------|
|  | <b>January 31,</b>        |             | <b>January 31,</b>      |             |
|  | <b>2007</b>               |             | <b>2006</b>             |             |
|  | <b>2007</b>               | <b>2006</b> | <b>2007</b>             | <b>2006</b> |
| Risk free interest rate                        | 4.57%                     | 4.44%       | 4.58%                   | 4.28%       |
| Expected Volatility                            | 105.73%                   | 101.21%     | 106.18%                 | 105.64%     |
| Expected Life (years)                          | 3.53                      | 2.18        | 3.53                    | 2.18        |
| Weighted average fair value of options granted | \$ 2.93                   | \$ 0.73     | \$ 2.87                 | \$ 0.82     |

The Company recorded \$77,000 of expense during the quarter ending January 31, 2007 due to a modification of options held by the Chief Financial Officer, who resigned in January 2007. Pursuant to a lockup agreement, NaviSite amended his option agreements to extend the time that vested options could be exercised from 90 days from termination to 227 days from termination. Modifications to option agreements under SFAS 123R require a remeasurement of the option based upon a comparison of the fair value of the option immediately before the modification and immediately following the modification.

In addition, the Company estimates forfeitures when recognizing compensation expense and will adjust the estimate of forfeitures when they are expected to differ. For the three months and six months ended January 31, 2007 we estimated that 5% of options granted will be forfeited prior to the first vesting tranche. For the three and six months ended January 31, 2006, we estimated that 15% of options granted would be forfeited before the first vesting tranche. Forfeitures after the first vesting tranche are estimated to not be material.

As of January 31, 2007, the total remaining unrecognized compensation cost related to nonvested awards is \$4.9 million. The weighted average period over which the cost is expected to be recognized is 2.73 years.

The following table reflects stock option activity under the Company's equity incentive plans for the six months ended January 31, 2007.

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

|                                       | Number<br>of<br><br>Shares | Weighted<br>Average<br>Exercise<br><br>Price | Weighted<br>Average<br>Remaining<br>Contractual<br><br>Term | Aggregate<br>Intrinsic<br>Value<br><br>(in<br>thousands) |
|---------------------------------------|----------------------------|--|---|--|
| Options outstanding, July 31, 2006    | 6,590,793                  | \$2.82                                       |   | \$   |
| Granted                               | 1,138,210                  | \$4.09                                       |   | \$   |
| Exercised                             | (420,666)                  | \$2.43                                       |   | \$   |
| Forfeited or expired                  | (509,630)                  | \$2.65                                       |   | \$   |
| Options outstanding, January 31, 2007 | 6,798,707                  | \$3.07                                       | 8.17  | \$ 16,347  |
| Options exercisable, January 31, 2007 | 4,200,794                  | \$3.12                                       | 7.65  | \$ 10,025  |

The company has a policy of issuing new shares to satisfy its stock option exercises.

In conjunction with the Financial Accounting Standards Board Staff Position No. FAS 123(R)-3, Transition Election Related to Accounting for Tax Effects of Share-Based Payment Awards, the Company elected to adopt the alternative transition method for calculating the tax effects of stock-based compensation pursuant to SFAS 123(R). The alternative transition method includes simplified methods to establish the beginning balance of the additional paid-in capital pool related to the tax effects of employee stock-based compensation, and to determine the subsequent effect on the additional paid-in capital pool and the statements of cash flows of the tax effects of employee stock-based compensation awards that were outstanding upon the adoption of SFAS 123(R).

**(j) Net Loss Per 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, using either the if-converted method for convertible preferred stock and notes or the treasury stock method for warrants and options, unless amounts are anti-dilutive.

For the three and six months ended January 31, 2007 and 2006, net loss per basic and diluted share is based on weighted average common shares and excludes any common stock equivalents, as they would be anti-dilutive due to the reported losses. For the three and six months ended January 31, 2007, there were 3,838,072 and 3,280,415 of dilutive shares, respectively, related to warrants and employee stock options that were excluded as they have an anti-dilutive effect due to the net loss during these periods. For the three and six months ended January 31, 2006, there were 6,250 of dilutive shares, related to warrants and employee stock options that were excluded as they have an anti-dilutive effect due to the net loss during these periods.

**(k) 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.

**(l) 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, cost of revenue and expenses. Translation gains and losses are deferred and accumulated as a separate component of stockholders' equity (deficit), ( Accumulated other comprehensive income ).





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**(m) 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 utilizes interest rate derivatives to protect against rising interest rates on a portion of its floating rate debt and did not qualify to apply 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 are recognized over the life of the agreements as other income/ (expense). 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.

**(n) Recent Accounting Pronouncements**

In February 2007, the Financial Accounting Standards Board ( FASB ) issued Statement of Financial Accounting Standards No. 159 ( FAS 159 ), The Fair Value Option for Financial Assets and Liabilities . FAS 159 permits entities to choose to measure many financial instruments and certain other items at fair value. FAS 159 will be effective for the Company's fiscal year beginning August 1, 2008. Early adoption is permitted. The Company has not determined the impact, if any, that adopting this standard may have on its consolidated financial position or results of operations.

In September 2006, the Securities and Exchange Commission ( SEC ) issued Staff Accounting Bulletin No. ( SAB 108 ) which provides interpretive guidance on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a current year misstatement. SAB 108 is effective for fiscal years ending after November 15, 2006. We are currently evaluating the effect, if any, that this pronouncement will have on our financial results.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements ( FAS 157 ). FAS 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. The provisions of FAS 157 are effective for fiscal years beginning after November 15, 2007. The Company is currently evaluating the impact of the provisions of FAS 157.

In June 2006, the Emerging Issues Task Force ( EITF ) reached a consensus on EITF 06-3, How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement . EITF 06-3 provides that taxes imposed by a governmental authority on a revenue producing transaction between a seller and a customer should be shown in the income statement on either a gross or a net basis, based on the entity's accounting policy, which should be disclosed pursuant to APB Opinion No. 22, Disclosure of Accounting Policies. If such taxes are significant, and are presented on a gross basis, the amounts of those taxes should be disclosed. EITF 06-3 must be applied to financial reports for interim and annual reporting periods beginning after December 15, 2006. We are currently evaluating the impact EITF 06-3 will have on the presentation of our consolidated financial statements.

In June 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes ( FIN 48 ). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in the Company's financial statements in accordance with FASB Statement No. 109, Accounting for Income Taxes. The provisions of FIN 48 are effective for fiscal years beginning after December 15, 2006. We are currently evaluating the impact the provisions of FIN 48 will have on our financial results.

In February 2006, the FASB issued SFAS No. 155, Accounting for Certain Hybrid Financial Instruments an amendment of FASB Statements No. 133 and 140 . SFAS No. 155 (1) permits fair value re-measurement for any hybrid financial instrument that contains an embedded derivative that would otherwise require bifurcation, (2) clarifies which interest-only strips and principal-only strips are not subject to the requirements of FASB Statement No. 133, (3) establishes a requirement to evaluate interests in securitized financial assets to identify interests that are

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freestanding derivatives or that are hybrid financial instruments that contain an imbedded derivative requiring bifurcation, (4) clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives, and (5) amends FASB Statement No. 140 to eliminate the prohibition on a qualifying special-purpose entity from holding a derivative financial instrument that pertains to a beneficial interest in other than another derivative financial instrument. SFAS No. 155 is effective August 1, 2007 and we are currently evaluating the effect, if any, that this pronouncement will have on our future financial results.

**(3) Impairment of Long-Lived Assets**

The Company did not record any impairment charge during the three months and six months ended January 31, 2007 and 2006.

**(4) Property and Equipment**

Property and equipment at January 31, 2007 and July 31, 2006 are summarized as follows:

|   | <b>January<br/>31,<br/>2007</b> | <b>July 31,<br/>2006</b> |
|---|---------------------------------|--------------------------|
|   | <b>(In thousands)</b>           |                          |
| Office furniture and equipment                  | \$ 3,325                        | \$ 3,303                 |
| Computer equipment                              | 48,256                          | 45,075                   |
| Software licenses                               | 12,030                          | 11,216                   |
| Leasehold improvements                          | 10,159                          | 9,958                    |
|   | 73,770                          | 69,552                   |
| Less: Accumulated depreciation and amortization | (59,387)                        | (54,638)                 |
| Property and equipment, net                     | \$ 14,383                       | \$ 14,914                |

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.

Equipment valued at approximately \$0.7 million and \$1.2 million was purchased under capital leases during the three and six months ended January 31, 2007, respectively and approximately \$0.1 million and \$1.2 million for the three and six months ended January 31, 2006, respectively.

**(5) Intangible Assets**

The gross carrying amount and accumulated amortization as of January 31, 2007 and July 31, 2006 for customer lists related to prior acquisitions are as follows:

|                                | <b>January<br/>31,<br/>2007</b> | <b>July 31,<br/>2006</b> |
|--------------------------------|---------------------------------|--------------------------|
|                                | <b>(In thousands)</b>           |                          |
| Gross carrying amount          | \$ 29,791                       | \$ 29,791                |
| Less: Accumulated amortization | (20,192)                        | (18,104)                 |
| Customer lists, net            | \$ 9,599                        | \$ 11,687                |

Intangible asset amortization expense for the three and six months ended January 31, 2007 and 2006 aggregated \$1.0 million and \$2.1 million, and \$1.2 million and \$2.5 million, respectively. Customer lists are being amortized over estimated useful lives ranging from five to eight years. The amount reflected in the table below for fiscal year 2007 includes year to date amortization. Amortization expense related to intangible assets for the next five years is as follows:

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**Year Ending July 31,**  
**(In thousands)**

|      |         |
|------|---------|
| 2007 | \$3,932 |
| 2008 | \$3,044 |
| 2009 | \$1,868 |
| 2010 | \$1,005 |
| 2011 | \$ 988  |

**(6) Investment in Debt Securities**

In a privately negotiated transaction with Fir Tree Recovery Master Fund, LP and Fir Tree Value Partners, LDC, pursuant to an Assignment Agreement dated October 11, 2002 and in a series of open market transactions from certain other third-party holders, we acquired an aggregate principal amount of approximately \$36.3 million face value, 10% convertible senior notes (Interliant Notes) due in 2006 of Interliant, Inc. (Interliant) for a total consideration of approximately \$2.0 million. Interliant was a provider of managed services, which filed a petition under Chapter 11 of Title 11 of the United States Bankruptcy Code in the Southern District of New York (White Plains) on August 5, 2002, and we made this investment with the intention of participating in the reorganization/sale of Interliant.

On May 16, 2003, the Bankruptcy Court confirmed us as the successful bidder for the purchase of the Interliant Assets. We used \$0.6 million of the first projected distributions to be made on our Interliant Notes as partial payment for the assets acquired. As such, we have reduced the carrying value of the Interliant Notes by this amount. On September 30, 2004, the Third Amended Plan of Liquidation of Interliant and its affiliated debtors became effective. As a result of unfavorable facts and circumstances occurring in the fourth quarter of fiscal year 2005, as learned from bankruptcy counsel, which negatively impacted the recoverability of our investment, the Company recorded an impairment charge in the amount of \$1.1 million, reducing the carrying value of the Interliant Notes to approximately \$0.2 million. On January 29, 2007, the final claim in the bankruptcy case was settled and all remaining assets were distributed to the creditors of the Estate. The Company received approximately \$0.15 million in this final distribution and the difference between the carrying value and the amount received was included in Other income (expense), net in the accompanying Condensed Consolidated Statements of Operations for the three and six months ended January 31, 2007.

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

Accrued expenses and other current liabilities consist of the following:

|   | <b>January<br/>31,<br/>2007</b> | <b>July 31,<br/>2006</b> |
|---|---------------------------------|--------------------------|
|   | <b>(In thousands)</b>           |                          |
| Accrued payroll, benefits and commissions           | \$ 3,920                        | \$ 4,331                 |
| Accrued accounts payable                            | 3,604                           | 2,905                    |
| Accrued interest                                    | 913                             | 913                      |
| Accrued impairment                                  | 932                             | 1,360                    |
| Accrued sales/use, property and miscellaneous taxes | 922                             | 1,070                    |
| Other accrued expenses and current liabilities      | 2,729                           | 3,153                    |
|   | <b>\$ 13,020</b>                | <b>\$ 13,732</b>         |

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**(8) Debt**

Debt consists of the following:

|   | <b>January<br/>31,<br/>2007</b> | <b>July 31,<br/>2006</b> |
|---|---------------------------------|--------------------------|
|   | <b>(In thousands)</b>           |                          |
| Term Loan, net of discount                | \$ 63,536                       | \$ 61,345                |
| Notes payable to the AppliedTheory Estate | 6,000                           | 6,000                    |
| Notes payable to the Atlantic Investors   |                                 | 3,000                    |
| Notes payable to landlord                 | 10                              | 319                      |
| Other notes payable                       | 553                             | 129                      |
| <b>Total</b>                              | <b>70,099</b>                   | <b>70,793</b>            |
| Less current portion                      | 10,825                          | 8,115                    |
| <b>Long-term debt</b>                     | <b>\$ 59,274</b>                | <b>\$ 62,678</b>         |

**(a) Term Loan and Revolving Credit Facility**

On April 11, 2006, we entered into a senior secured Term Loan and senior secured Revolving Credit Facility (the Credit Facility) with Silver Point Finance LLC, (the Lender) to repay certain maturing debt and increase borrowing available for corporate purposes. The Term Loan consists of a five year single-draw Term Loan in the aggregate amount of \$70 million. Borrowings under the Term Loan are guaranteed by the Company and all of its subsidiaries. During the first twelve months of the loan, we are required to make quarterly interest only payments to the Lender and commencing one year after closing date of the loan, we are also scheduled to make quarterly repayments of the principal. The maturity date of the Term Loan is April 11, 2011. The Lender is entitled to prepayment of the outstanding balance under the Term Loan, if any, upon the occurrence of various events, including, among others, if the Company sells assets and does not reinvest the proceeds in assets, receives cash proceeds from the incurrence of any indebtedness, has excess cash, or closes an equity financing transaction, provided that the first \$10 million plus 50% of the remaining net proceeds from an equity financing shall not be subject to the mandatory prepayment requirement. Generally, prepayments are subject to a prepayment premium ranging from 8%-1% depending upon the timing of the prepayment (see Note 10 for discussion of the valuation of this prepayment premium). The unpaid amount of the Term Loan and accrued interest and all other obligations shall become due and payable immediately upon occurrence and continuation of any event of default. Under the Term Loan agreement, we must comply with various financial and non-financial covenants. The financial covenants include among others, minimum fixed charge coverage ratio, maximum consolidated leverage ratio, minimum consolidated EBITDA and maximum annual capital expenditures. The primary non-financial covenants limit our ability to pay dividends, make investments, engage in transactions with affiliates, sell assets, conduct mergers or acquisitions, incur indebtedness or liens, alter capital structure and sell stock.

Outstanding amounts of the Term Loan bear interest at either: (a) 7% per annum plus, the greater of (i) Prime Rate, and (ii) the Federal Funds Effective Rate plus 3%, or (b) 8% plus the floating rate of LIBOR. To the extent interest payable on the Term Loan (a) exceeds the LIBOR Rate plus 5% in year one or (b) exceeds the LIBOR Rate plus 7% for the years thereafter, such amounts exceeding the threshold will be capitalized and added to the outstanding principal amount of the Term Loan and shall incur interest. The interest rate for the Term Loan was 13.36% as of 1/31/07. Outstanding amounts under the Revolving Credit Facility bear interest at either: (a) 7% per annum plus, the greater of (i) Prime Rate, and (ii) the Federal Funds Effective Rate plus 3%, or (b) 8% plus the floating rate of LIBOR.

Interest is payable in arrears on the last day of the month for Base Rate loans, and the last day of the chosen interest period (one, two or three months) for LIBOR Rate loans. We are required to maintain Interest Rate Agreements constituting caps with respect to an aggregate notional principal amount of a portion of the Loan, to limit the Unadjusted LIBOR Rate Component of the interest costs to the Company (see Note 9).

The amount borrowed was used to repay our accounts receivable financing line, convertible notes and interest payable and to pay transaction fees and expenses relating to the loan. In addition, we borrowed \$6.4 million which is being held in an escrow account to pay off notes payable to the AppliedTheory Estate. As of January 31, 2007, we had \$71.7 million outstanding under the Term Loan and had accrued approximately \$0.4 million in interest related to this Term Loan.

In connection with the Credit Facility, the Company issued two warrants to purchase an aggregate of

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3,514,933 shares of common stock of the Company at an exercise price of \$0.01 per share. These warrants were not exercisable until after 90 days following the closing date of the Credit Facility and will expire on April 11, 2016. The warrants were fair valued using the Black-Scholes option-pricing model and are recorded in our Condensed Consolidated Balance Sheets as a discount to the loan amount of \$9.1 million at inception and \$7.5 million at January 31, 2007 and are being amortized into interest expense over the five-year term of the Credit Facility. During the second quarter of fiscal year 2007, we borrowed and repaid \$1.0 million under the Credit Facility. During the month of January 2007, Silverpoint exercised warrants for the purchase of 287,500 share of common stock in connection with the public offering of the Company's common stock. (see Note 12)

On February 13, 2007, the Company entered into Amendment No. 4 and Waiver to Credit and Guaranty Agreement (the Amendment) with Silver Point. Under the Amendment, the Lenders provided to the Company an additional term loan in the original principal amount of \$3,762,753 (the Supplemental Term Loan). Pursuant to the Credit Agreement, the Lenders had the right to require the Company to borrow amounts on substantially the same terms as the existing Term Loan.

The Supplemental Term Loan was funded in full on February 13, 2007. The terms of the Supplemental Term Loan are the same as the existing Term Loan. The Company will use amounts borrowed under the Supplemental Term Loan for working capital and other general corporate purposes.

On February 13, 2007, in connection with the Amendment, the Company issued two warrants to Silver Point to purchase an aggregate of 415,203 shares of common stock at an exercise price of \$0.01 per share (representing 1% of the fully diluted common equity of the Company). The warrants will be fair valued using the Black Scholes option pricing model will be recorded in the Company's third quarter results as a discount to the loan and amortized over the remaining life of the credit facility.

**(b) Note Payable to Atlantic Investors, LLC**

On January 29, 2003, we entered into a \$10.0 million Loan and Security Agreement (Atlantic Loan) with Atlantic Investors, LLC (Atlantic), a related party. The Atlantic Loan bears an interest rate of 8% per annum. On April 11, 2006, the Company entered into an Amended and Restated Loan Agreement with Atlantic, in connection with and as a condition precedent to the Credit Facility with Silver Point, which amended and restated the existing loan agreement between the Company and Atlantic dated January 29, 2003. Under the Atlantic amendment and related transaction documents, Atlantic agreed to reduce the availability of the Atlantic Loan to the amount outstanding as of April 11, 2006 of \$3.0 million and approximately \$0.7 million of accrued interest, agreed that this indebtedness shall be an unsecured obligation of the Company, agreed to subordinate this indebtedness to amounts owed by the Company to Silver Point and agreed to extend the maturity date of the loan to the earlier of the date that is 90 days after the earlier of: (a) April 11, 2011, and (b) the date all obligations under the Silver Point Credit Facility have been paid in full.

The principal and accrued interest of the Atlantic Loan from time to time became convertible into shares of the Company's common stock at \$2.81 per share, (the market price of our stock on April 11, 2006), 90 days following April 11, 2006.

In January 2007, Atlantic converted all of the remaining principal and accrued interest of \$3,863,610 into 1,374,950 shares of the Company's common stock. (see Note 12)

**(c) Revolving Credit Facility with Atlantic Investors, LLC**

On April 11, 2006, we entered into an unsecured subordinated Revolving Credit Agreement with Atlantic Investors LLC, in connection with and as a condition precedent to the Silver Point credit facility, whereby the Company established a subordinated revolving credit facility with Atlantic (the Atlantic Facility) in the amount not to exceed \$5 million. Credit advances under the Atlantic Facility shall bear interest at either: (a) 7% per annum plus, the greater of (i) Prime Rate, and (ii) the Federal Funds Effective Rate plus 3%, or (b) 8% plus the floating rate of LIBOR. Interest may, at the Company's option, be paid in cash or promissory notes. All

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outstanding amounts under the Atlantic Facility shall be paid in full by the Company no later than the date that is 90 days after the earlier of: (a) April 11, 2011, and (b) the date all obligations under the Credit Facility have been paid in full.

We plan to use the proceeds of the Atlantic Credit Facility, if necessary, for general corporate and working capital purposes of the Company. As of January 31, 2007, there were no borrowings outstanding under the Atlantic Credit Facility.

**(d) Notes Payable to the AppliedTheory Estate**

As part of CBTM's acquisition of certain AppliedTheory assets, CBTM made and issued two unsecured promissory notes totaling \$6.0 million (Estate Liability) due to the AppliedTheory Estate on June 13, 2006. The Estate Liability bears interest at 8% per annum, which is due and payable annually. At January 31, 2007, we had approximately \$0.5 million in accrued interest related to these notes. At January 31, 2007, the Company had retained the borrowed \$6.4 million from Silver Point Finance as part of the Term Loan, and maintained these amounts in an escrow account, reserved to repay these notes. This \$6.4 million is included in Prepaid expenses and other current assets on our Condensed Consolidated Balance Sheets. In July 2006, the Company reached agreement with the secured creditors of AppliedTheory to settle certain claims against the estate of AppliedTheory and repay the outstanding notes including accrued interest for approximately \$5.0 million. The settlement agreement is currently awaiting approval by the bankruptcy court and is expected to become final within the next nine months.

**(e) Notes Payable to Landlord**

As part of an amendment to our 400 Minuteman Road lease, \$2.2 million of our future payments to the landlord of our 400 Minuteman Road facility was transferred into a note payable (Landlord Note). The \$2.2 million represents leasehold improvements made by the landlord, on our behalf, to the 400 Minuteman location in order to facilitate the leasing of a portion of the facility (First Lease Amendment), as well as common area maintenance and property taxes associated with the space. The Landlord Note bears interest at an annual rate of 11% and calls for 36 equal monthly payments of principal and interest. The final payment was due and paid in November 2006.

In addition, during fiscal year 2004, we paid \$120,000 and we entered into a separate \$150,000 note (Second Landlord Note) with the landlord for additional leasehold improvements to facilitate a subleasing transaction involving a specific section of the 400 Minuteman Road location. The Second Landlord Note bears interest at an annual rate of 11% and calls for 36 equal monthly payments of principal and interest, with the final payment due and subsequently paid on March 1, 2007.

**(9) Derivative Instruments**

In May 2006, the Company purchased an interest rate cap on a notional amount of 70% of the outstanding principal of the Term Loan (see Note 8) until expiration in April 2011. The Company paid approximately \$320,000 to lock in a maximum LIBOR interest rate of 6.5% that could be charged on the notional amount during the term of the agreement. As of January 31, 2007, the fair value of the interest rate derivative was approximately \$71,000 which is included in Other assets in the Company's Condensed Consolidated Balance Sheets. The change in fair value for the three and six months ended January 31, 2007 was approximately \$31,000 and \$139,000, respectively. The change in fair value was charged to Other income/(expense), net in the accompanying Condensed Consolidated Statement of Operations.

The prepayment penalty of our Term Loan was determined to be an embedded derivative which was required to be separately valued from the Term Loan. The Company's third party valuation consultant calculated the fair value of this embedded derivative to be approximately \$867,000 which has been included in the Condensed Consolidated Balance Sheets as a discount to the Term Loan with an offsetting amount included in Other long-term liabilities.



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Amortization of the embedded derivative, calculated on a straight line basis, will be included in interest expense and will reduce the discount to the Term Loan over the term of the loan. Any changes in the valuation of the embedded derivative will be recorded as an adjustment to any interest expense previously recorded and to the discount to the Term Loan with an offsetting adjustment to Other long-term liabilities .

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

*Abandoned Leased Facilities.* During the second quarter of fiscal year 2007 and 2006, no additional leases were abandoned and no new lease abandonment charges were recorded.

All impairment expense amounts recorded are included in the caption Impairment, restructuring and other in the accompanying Condensed Consolidated Statements of Operations.

Details of activity in the lease exit accrual by facility for the six months ended January 31, 2007 are as follows (in thousands):

| <b>Lease Abandonment</b> | <b>Balance<br/>July 31,<br/>2006</b> | <b>Expense</b> | <b>Purchase<br/>Accounting<br/>and<br/>Other<br/>Adjustments</b> | <b>Payments,<br/>less<br/>accretion<br/>of<br/>interest</b> | <b>Balance<br/>January<br/>31,<br/>2007</b> |
|--------------------------|--------------------------------------|----------------|--|---|---|
| <b>Costs for:</b>        |                                      |                |  |   |   |
| Andover, MA              | \$ 587                               |                |  | \$ (96)   | \$ 491                                      |
| Chicago, IL              | 786                                  | (249)          |  | (77)  | 460   |
| Houston, TX              | 880                                  |                |  | (203)   | 677   |
| Syracuse, NY             | 417                                  |                |  | (157)   | 260   |
| Syracuse, NY             | 76                                   |                |  | (16)  | 60  |
| San Jose, CA             | 211                                  | (38)           |  | (173)   |   |
| Atlanta, GA              | 31                                   |                | (18)   | (13)  |   |
|                          | \$ 2,988                             | \$ (287)       | \$ (18)  | \$ (735)  | \$ 1,948                                    |

Minimum annual rental commitments under operating leases and other commitments are as follows as of January 31, 2007:

| <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 <sup>(a)</sup> | \$ 78,304    | \$ 10,825                       | \$ 7,937      | \$ 10,500             | \$ 12,300     | \$ 36,742     | \$                      |
| Interest on debt <sup>(b)</sup>     | 34,692       | 9,028                           | 8,346         | 7,310                 | 5,963         | 4,045         |                         |
| Capital leases                      | 3,102        | 2,469                           | 514           | 42                    | 42            | 35            |                         |
| Bandwidth commitments               | 1,866        | 1,506                           | 360           |                       |               |               |                         |
| Maintenance for hardware/software   | 372          | 366                             | 6             |                       |               |               |                         |
| Property leases <sup>(c)(d)</sup>   | 54,672       | 10,153                          | 8,740         | 6,850                 | 3,846         | 3,768         | 21,315                  |

\$ 173,008    \$ 34,347    \$ 25,903    \$ 24,702    \$ 22,151    \$ 44,590    \$ 21,315

(a) *Short/Long-term debt does not tie to the Condensed Consolidated Balance Sheets due to recorded discounts for warrants and embedded derivative.*

(b) *Interest on Term Loan assumes LIBOR is fixed at 5.36%.*

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

(d) *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.*

With respect to the property lease commitments listed above, certain cash amounts are restricted pursuant to terms of lease agreements with landlords. At January 31, 2007, restricted cash of approximately \$0.9 million 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**

On or about June 13, 2001, Stuart Werman and Lynn McFarlane filed a lawsuit against us, BancBoston Robertson Stephens, an underwriter of our initial public offering in October 1999, Joel B. Rosen, our then chief executive officer, and Kenneth W. Hale, our then chief financial officer. The suit was filed in the United States District Court for the Southern District of New York, and generally alleges that the defendants violated federal securities laws by not disclosing certain actions allegedly taken by Robertson Stephens in connection with our initial public offering. The suit 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. Four other substantially similar lawsuits were filed between June 15, 2001 and July 10, 2001 by Moses Mayer (filed June 15, 2001), Barry Feldman (filed June 19, 2001), David Federico (filed June 21, 2001) and Binh Nguyen (filed July 10, 2001). Robert E. Eisenberg, our president at the time of the initial public offering in 1999, was named as a defendant in the Nguyen lawsuit. The Federico lawsuit sought certification of a plaintiff class consisting of all persons who acquired shares of our common stock between October 22, 1999 and

June 12, 2001, and also named additional underwriter defendants, including J. P. Morgan Chase, First Albany Companies, Inc., Bank of America Securities, LLC, Bear Stearns & Co., Inc., B. T. Alex. Brown, Inc., Chase Securities, Inc., CIBC World Markets, Credit Suisse First Boston Corp., Dain Rauscher, Inc., Deutsche Bank Securities, Inc., The Goldman Sachs Group, Inc., J. P. Morgan & Co., J. P. Morgan Securities, Lehman Brothers, Inc., Merrill Lynch, Pierce, Fenner & Smith, Inc., Morgan Stanley Dean Witter & Co., Robert Fleming, Inc. and Salomon Smith Barney, Inc.

Those five cases, along with lawsuits naming more than 300 other issuers and over 50 investment banks which have been sued in substantially similar lawsuits, have been assigned to the Honorable Shira A. Scheindlin (the Court) for all pretrial purposes (the IPO Securities Litigation). On September 6, 2001, the Court entered an order consolidating the five individual cases involving us and designating *Werman v. NaviSite, Inc., et al.*, Civil Action No. 01-CV-5374 as the lead case. A consolidated, amended complaint was filed thereafter on April 19, 2002 (the Class Action Litigation) on behalf of plaintiffs Arvid Brandstrom and Tony Tse 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. Plaintiffs uniformly allege that all defendants, including the NaviSite Defendants, violated the federal securities laws (i.e., Sections 11 and 15 of the Securities Act, Sections 10(b) and 20(a) of the Exchange Act and Rule 10b-5) by issuing and selling our common stock pursuant to the October 22, 1999 initial public offering, without disclosing to investors that some of the underwriters of the offering, including the lead underwriters, had solicited and received extensive and 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. At this time, plaintiffs have not specified the amount of damages they are seeking in the Class Action Litigation.

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**(Unaudited)**

Between July and September 2002, the parties to the IPO Securities Litigation briefed motions to dismiss filed by the underwriter defendants and the issuer defendants, including NaviSite. On November 1, 2002, the Court held oral argument on the motions to dismiss. The plaintiffs have since agreed to dismiss the claims against Messrs. Rosen, Hale and Eisenberg without prejudice, in return for their agreement to toll any statute of limitations applicable to those claims. By stipulation entered by the Court on November 18, 2002, Messrs. Rosen, Hale and Eisenberg were dismissed without prejudice from the Class Action Litigation. On February 19, 2003, an opinion and order was issued on defendants' motion to dismiss the IPO Securities Litigation, essentially denying the motions to dismiss of all 55 underwriter defendants and of 185 of the 301 issuer defendants, including NaviSite.

On June 30, 2003, our Board of Directors considered and authorized us to negotiate a settlement of the pending Class Action Litigation substantially consistent with a memorandum of understanding negotiated among proposed class plaintiffs, the issuer defendants and the insurers for such issuer defendants. Among other contingencies, any such settlement would be subject to approval by the Court. Plaintiffs filed on June 14, 2004, a motion for preliminary approval of the Stipulation And Agreement Of Settlement With Defendant Issuers And Individuals (the Preliminary Approval Motion). On February 15, 2005, the Court approved the Preliminary Approval Motion in a written opinion which detailed the terms of the settlement stipulation, its accompanying documents and schedules, the proposed class notice and, with a modification to the bar order to be entered, the proposed settlement order and judgment. A further conference was held on April 13, 2005, at which time the Court considered additional submissions but did not make final determinations regarding the exact form, substance and program for notifying the proposed settlement class. On August 31, 2005, the Court entered a further Preliminary Order in Connection with Settlement Proceedings (the

Preliminary Approval Order), which granted preliminary approval to the issuer's settlement with the plaintiffs in the IPO Securities Litigation. The Court subsequently held a Fed. R. Civ. P. 23 fairness hearing on April 24, 2006 in order to consider the written and oral submissions addressing whether the Court should enter final approval of the settlement. On November 15, 2006, a second amendment to the settlement stipulation was filed (Amendment # 2). Amendment #2 modifies how the Recovery Deficit, as defined in the settlement stipulation, is to be calculated and also deletes certain provisions pursuant to which the insurers could have recouped certain Notice Costs, Litigation Trust Costs and Defense Costs as defined in the settlement stipulation. The matter was taken under advisement and remains pending with the Court.

On October 13, 2004, the Court granted a contested motion for class certification in a sub-group of cases consolidated in the IPO Securities Litigation. On December 5, 2006, a panel of the United States Court of Appeals for the Second Circuit (the Second Circuit) issued an opinion vacating the Court's class certification decision because, among others, the plaintiffs-appellees therein could not satisfy the predominance requirement for a Fed. R. Civ. P. 23(b)(3) class action. On January 5, 2007, the plaintiffs-appellees filed a petition with the Second Circuit for rehearing and rehearing en banc (the Petition). In response to a January 24, 2007 order by the Second Circuit, on February 7, 2007, defendants-appellants filed a response to the Petition. The Petition remains pending in the Second Circuit. Absent modification by or further proceedings in the Second Circuit, the matter is to be remanded to the Court for further proceedings. The effect, if any, of the Second Circuit's ruling on the pending issuers' settlement is not known at this time.

If the proposed issuers' settlement is completed and then approved by the Court without further modifications to its material terms, we and the participating insurers acting on our behalf may be responsible for providing funding of approximately \$3.4 million towards the total amount plaintiffs are guaranteed by the proposed issuer's settlement to recover in the IPO Securities Litigation. The amount of the guarantee allocable to us could be reduced or eliminated in its entirety in the event that plaintiffs are able to recover some or all of the total amount of such overall guarantee from settlements with or judgments obtained against the non-settling defendants. Even if no additional recovery is obtained from any of the non-settling defendants, the settlement amount allocable to us is expected to be fully covered by our existing insurance policies and is not expected to have a material effect on our business, financial condition, results of operations or cash flows.

We believe that the allegations against us are without merit and, if the settlement is not approved by the Court and finalized, 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

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

business, financial condition, results of operations or cash flows.

**(11) Income Tax Expense**

The Company recorded \$0.3 million and \$0.6 million of deferred income tax expense during the three and six months ended January 31, 2007 and 2006, 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 resulted from tax goodwill amortization related to the Surebridge acquisition and the acquisition of Applied Theory Corporation by ClearBlue Technologies Management, Inc. The acquired goodwill and intangible assets for both acquisitions are amortizable for tax purposes over fifteen years. For financial statement purposes, goodwill is not amortized for either acquisition 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.

**(12) Stockholders' Equity**

**Unregistered Sales of Equity Securities**

On January 2, 2007, the Company, pursuant to the terms of the Amended and Restated Loan Agreement (the Amended Loan Agreement ) dated as of April 11, 2006, received notice from Atlantic of its election to convert the full amount of the Company's outstanding repayment obligations under the Amended Loan Agreement into 1,374,950 shares of the Company's common stock. Under the Amended Loan Agreement, if the Company did not pay in full the Company's outstanding repayment obligations by July 10, 2006, Atlantic had the right, but not the obligation, to convert such outstanding amounts into shares of the Company's common stock by dividing (i) the dollar value of the outstanding obligations by (ii) \$2.81, (the market price per share of our common stock on April 11, 2006), rounded to the nearest whole share.

The shares issuable upon conversion of the outstanding repayment obligations under the Amended Loan Agreement 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 a sale by the Company not involving a public offering. No underwriters were involved with the issuance of the shares issuable upon conversion of the outstanding repayment obligations under the Amended Loan Agreement.

**Public Offering**

On January 19, 2007, 9,952,500 shares of the Company's common stock, par value \$0.01, was sold in a public offering by certain shareholders, at a per share value of \$4.50. The Company received no proceeds from this sale of shares by these selling shareholders.



**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 1.A. 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, Inc. provides Application Management, Hosting and Professional services for mid- to large-sized 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. We provide services throughout the information technology lifecycle. We are dedicated to delivering quality services and meeting rigorous standards, including SAS 70, 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, we are able to leverage our application services platform, NaviView™, to enable software to be delivered on-demand over the Internet, providing an alternative delivery model to the traditional licensed software model. As the platform provider for an increasing number of independent software vendors (ISVs), we enable solutions and services to a wider and growing customer base.

Our services include:

***Application Management***

**Application management services** Defined services provided for specific packaged applications that are incremental to managed services. Services can include monitoring, diagnostics and problem resolution. Frequently sold as a follow-on to a professional services project.

**Software as a Service** Enablement of Software as a Service to the ISV community.

**Development Services** Services include eBusiness/Web solutions, enterprise integration, business intelligence, content management and user interface design.

**Custom Services** Services include custom application management and remote infrastructure management.

***Hosting Services***

**Managed services** Support provided for hardware and software located in a data center. Services include business continuity and disaster recovery, connectivity, content distribution, database administration and performance tuning, desktop support, hardware management, monitoring, network management, security management, server and operating system management and storage management.

**Content Delivery** Includes the delivery of software electronically using NaviSite technology to manage version control and accelerated content distribution.

**Colocation** 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.



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***Professional Services***

For leading enterprise software applications such as Oracle, PeopleSoft, JD Edwards and Siebel Systems, NaviSite Professional Services helps organizations plan, implement and maintain these applications.

Optimize scalable, business-driven software solutions. Specific services include planning, implementation, maintenance, optimization and compliance services.

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, public sector and software, through our direct sales force and sales channel relationships.

Our managed application services are facilitated by our proprietary NaviView™ collaborative application management platform. Our NaviView™ platform enables us to provide highly efficient, effective and customized management of enterprise applications and information technology. 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. We also use this platform for electronic software distribution for software vendors and to enable software to be delivered on-demand over the Internet, providing an alternative delivery model to the traditional licensed software model.

We believe that the combination of NaviView™ with our physical infrastructure and technical staff gives us a unique ability to provision on-demand application services for software providers for use by their customers. NaviView™ is application and operating platform neutral as its on-demand provisioning capability is not dependent on the individual software application. Designed to enable enterprise software applications to be provisioned and used as an on-demand solution, the NaviView™ technology allows us to offer new solutions to our software vendors and new products to our current customers.

We currently operate in 13 data centers in the United States and one data center in the United Kingdom. We believe that our data centers and infrastructure have the capacity necessary to expand our business for the foreseeable future. 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 are able to disrupt our customers' operations.

We currently service approximately 950 hosted customers. Our hosted customers typically enter into service agreements for a term of one to three years, which provide for monthly payment installments, providing us with a base of recurring revenue. Our revenue increases by adding new customers or providing additional services to existing customers. Our overall base of recurring revenue is affected by new customers, renewals and terminations of agreements with existing customers.

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 CBTM; in February 2003, we acquired Avasta; in April 2003, we acquired Conxion; in May 2003, we acquired assets of Interliant; in August 2003 and April 2004, we completed a common control merger with certain subsidiaries of CBT; 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, a New Delhi-based operation which is intended to expand our international capability. NaviSite India will provide 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.

**Results of Operations for the Three and Six Months Ended January 31, 2007 and 2006**

The following table sets forth the percentage relationships of certain items from our Condensed Consolidated

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Statements of Operations as a percentage of total revenue.

|                                     | <b>Three Months Ended</b> |             | <b>Six Months Ended</b> |             |
|-------------------------------------|---------------------------|-------------|-------------------------|-------------|
|                                     | <b>January 31,</b>        |             | <b>January 31,</b>      |             |
|                                     | <b>2007</b>               | <b>2006</b> | <b>2007</b>             | <b>2006</b> |
| Revenue                             | 99.7%                     | 99.8%       | 99.7%                   | 99.9%       |
| Revenue, related parties            | 0.3%                      | 0.2%        | 0.3%                    | 0.1%        |
| Total revenue                       | 100.0%                    | 100.0%      | 100.0%                  | 100.0%      |
| Cost of revenue                     | 68.0%                     | 71.1%       | 67.7%                   | 70.3%       |
| Total cost of revenue               | 68.0%                     | 71.1%       | 67.7%                   | 70.3%       |
| Gross profit                        | 32.0%                     | 28.9%       | 32.3%                   | 29.7%       |
| Operating expenses:                 |                           |             |                         |             |
| Selling and marketing               | 14.0%                     | 15.0%       | 13.4%                   | 13.9%       |
| General and administrative          | 19.4%                     | 19.4%       | 19.0%                   | 21.3%       |
| Impairment, restructuring and other | 0.0%                      | 1.4%        | 0.5%                    | 0.7%        |
| Total operating expenses            | 33.4%                     | 35.8%       | 31.9%                   | 35.9%       |
| Loss from operations                | (1.4)%                    | (6.9)%      | (0.4)%                  | (6.2)%      |
| Other income (expense):             |                           |             |                         |             |
| Interest income                     | 0.1%                      | 0.1%        | 0.1%                    | 0.1%        |
| Interest expense                    | (10.6)%                   | (7.7)%      | (10.9)%                 | (7.7)%      |
| Other income (expense), net         | 0.2%                      | 0.5%        | 0.4%                    | 0.5%        |
| Loss before income tax expense      | (11.7)%                   | (14.0)%     | (10.0)%                 | (13.3)%     |
| Income tax expense                  | (1.0)%                    | (1.1)%      | (1.0)%                  | (1.1)%      |
| Net loss                            | (12.6)%                   | (15.1)%     | (11.0)%                 | (14.4)%     |

**Comparison of the Three and Six Months Ended January 31, 2007 and 2006****Revenue**

We derive our revenue from managed IT services, including hosting, colocation 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 January 31, 2007 increased 14.8% to approximately \$30.2 million from approximately \$26.3 million for the three months ended January 31, 2006. The overall growth of approximately \$3.9 million in revenue was mainly due to the increased sales to new and existing customers. Revenue from related parties during the three months ended January 31, 2007 and 2006 totaled \$82,000 and \$41,000, respectively.

Total revenue for the six months ended January 31, 2007 increased 13.5% to approximately \$58.7 million from approximately \$51.7 million for the six months ended January 31, 2006. The overall growth of approximately \$7.0 million in revenue was mainly due to the increased sales to new and existing customers. Revenue from related parties during the six months ended January 31, 2007 and 2006 totaled \$176,000 and \$71,000, respectively. One

unrelated customer accounted for 8% and 10% of our total revenue during the first half of fiscal year 2007 and 2006, respectively.

**Table of Contents****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 January 31, 2007 increased approximately 9.6% to \$20.5 million during the second fiscal quarter of 2007 from approximately \$18.7 million during the second fiscal quarter of 2006. As a percentage of revenue, total cost of revenue decreased to 68.0% in the second fiscal quarter of 2007 from 71.1% in the second fiscal quarter of 2006 primarily related to the scaling of our relatively fixed cost infrastructure against increasing revenue. The overall increase in cost of revenue of \$1.8 million resulted primarily from increased salary and related expenses of approximately \$1.1 million due to increased headcount, increases in depreciation and amortization and facilities related charges of approximately \$0.3 million, an increase in billable expenses of approximately \$0.8 million, partially offset by a reduction in hardware and software maintenance costs and other expenses of approximately \$0.4 million.

Total cost of revenue for the six months ended January 31, 2007, increased approximately 9.4% to \$39.8 million from approximately \$36.4 million for the six months ended January 31, 2006. As a percentage of revenue, total cost of revenue decreased from 70.3% of revenue for the six months ended January 31, 2006 to 67.7% of revenue for the six months ended January 31, 2007 primarily related to the scaling of our relatively fixed cost infrastructure against increasing revenue. The overall increase in cost of revenue of approximately \$3.4 million resulted primarily from increased salary and related expenses of approximately \$1.8 million due to increased headcount, increases in depreciation and amortization and facilities related charges of approximately \$0.7 million, an increase in billable expenses of approximately \$1.3 million partially offset by a reduction in hardware and software maintenance costs and other expenses of approximately \$0.4 million.

Gross profit of approximately \$9.7 million for the three months ended January 31, 2007 increased approximately \$2.0 million, or 26.8%, from a gross profit of approximately \$7.6 million for the three months ended January 31, 2006. Gross profit for the second fiscal quarter of 2007 represented 32.0% of total revenue, compared to 28.9% of total revenue for the second fiscal quarter of 2006. Due to the fixed cost nature of our infrastructure, increased customer revenue resulted in incremental improvements in our operating margins.

Gross profit of approximately \$18.9 million for the six months ended January 31, 2007 increased approximately \$3.6 million, or 23.2%, from a gross profit of approximately \$15.3 million for the six months ended January 31, 2006. Gross profit for the second half of fiscal year 2007 represented 32.3% of total revenue, as compared to 29.7% of total revenue for the second half of fiscal year 2006. Due to the fixed cost nature of our infrastructure, increased customer revenue resulted in incremental improvements in our operating margins.

**Operating Expenses**

*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 6.7% to approximately \$4.2 million, or 14.0% of total revenue, during the three months ended January 31, 2007 from approximately \$4.0 million, or 15.0% of total revenue, during the three months ended January 31, 2006. The increase of approximately \$0.2 million resulted primarily from the increased salary and related expenses due to increased headcount.

Selling and marketing expense increased 9.0% to approximately \$7.9 million, or 13.4% of total revenue, during the six months ended January 31, 2007 from approximately \$7.2 million, or 13.9% of total revenue, during the six months ended January 31, 2006. The increase of approximately \$0.7 million resulted primarily from the increased salary and related expenses due to increased headcount.

*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.

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General and administrative expense increased 15.7% to approximately \$5.9 million, or 19.4% of total revenue, during the three months ended January 31, 2007 from approximately \$5.1 million, or 19.4% of total revenue, during the three months ended January 31, 2006. The increase of approximately \$0.8 million was primarily the result of a charge of \$0.6 million for secondary offering fees and approximately \$0.5 million for amortization of Silverpoint deal cost, partially offset by a decrease of approximately \$0.3 million in other general and administrative expenses.

General and administrative expense increased 1.6% to approximately \$11.2 million, or 19.0% of total revenue, during the six months ended January 31, 2007 from approximately \$11.0 million, or 21.3% of total revenue, during the six months ended January 31, 2006. The increase of approximately \$0.2 million was primarily the result of a charge of \$0.6 million for secondary offering fees and approximately \$0.8 million for amortization of Silver Point deal costs, partially offset by a decrease in bad debt expense of approximately \$0.4 million, \$0.4 million in miscellaneous fees and charges, \$0.2 million in legal fees and \$0.2 million in miscellaneous taxes.

**Operating Expenses    Impairment**

Costs associated with the abandonment of leased facilities and the impairment of property and equipment included in impairment, restructuring and other expense within operating expenses were approximately \$0.4 million during the three months ended January 31, 2006, whereas no impairment charges were recorded during the three months ended January 31, 2007.

We recorded a reduction in expense of \$0.3 million during the six months ended January 31, 2007, primarily due to revised assumptions due to securing a sublease of an impaired facility, as compared to a charge of \$0.4 million recorded during the six months ended January 31, 2006, associated with the abandonment of leased facilities and the impairment of property and equipment included in impairment, restructuring and other expense.

**Interest Income**

Interest income increased 61.5% to approximately \$42,000 during the three months ended January 31, 2007 from approximately \$26,000 during the three months ended January 31, 2006. The increase in interest income is mainly due to an increase in the rate of interest on our security deposits and interest earned on our escrow account.

Interest income increased 55.6% to approximately \$84,000 during the six months ended January 31, 2007 from approximately \$54,000 during the six months ended January 31, 2006. The increase in interest income is mainly due to an increase in the rate of interest on our security deposits and interest earned on our escrow account.

**Interest Expense**

Interest expense increased 58.3% to approximately \$3.2 million, or 10.6% of total revenue, during the three months ended January 31, 2007 from approximately \$2.0 million, or 7.7% of total revenue, during the three months ended January 31, 2006. The increase of \$1.2 million is primarily related to amounts drawn, during the third quarter of fiscal year 2006, on our term loan with Silver Point Finance, the addition of capital leases, and an increase in interest rate between our previous debt and the Silver Point facility.

Interest expense increased 61% to approximately \$6.4 million, or 10.9% of total revenue, during the six months ended January 31, 2007 from approximately \$4.0 million, or 7.7% of total revenue, during the six months ended January 31, 2006. The increase of \$2.4 million is primarily related to amounts drawn, during the third quarter of fiscal year 2006, on our term loan with Silver Point Finance, the addition of capital leases, and an increase in interest rate between our previous debt and the Silver Point facility.

**Other Income (Expense), Net**

Other income was approximately \$54,000 during the three months ended January 31, 2007, as compared to other income of approximately \$130,000 during the three months ended January 31, 2006. The other income recorded during the second fiscal quarter of 2007 is primarily attributable to rent from sublease of our facility at Las Vegas with a third party.

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Other income was approximately \$246,000 during the six months ended January 31, 2007, as compared to other income of approximately \$273,000 during the six months ended January 31, 2006. The other income recorded during the first six months of 2007 is primarily attributable to rent from sublease of our facility at Las Vegas with a third party and certain settlements with customers in favor of the Company.

**Income Tax Expense**

The Company recorded \$0.3 million and \$0.6 million of deferred income tax expense during the three and six months ended January 31, 2007 and 2006, 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 resulted from tax goodwill amortization related to the Surebridge acquisition and the acquisition of Applied Theory Corporation by ClearBlue Technologies Management, Inc. The acquired goodwill and intangible assets for both acquisitions are amortizable for tax purposes over fifteen years. For financial statement purposes, goodwill is not amortized for either acquisition 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.

**Liquidity and Capital Resources**

As of January 31, 2007, our principal sources of liquidity included cash and cash equivalents, a revolving credit facility of \$3.0 million provided by Silver Point Finance and a revolving credit facility with Atlantic Investors LLC, to borrow a maximum amount of \$5.0 million. We had a working capital deficit of \$9.4 million, including cash and cash equivalents of approximately \$3.0 million at January 31, 2007, as compared to a working capital deficit of \$9.1 million, including cash and cash equivalents of \$3.4 million, at July 31, 2006.

The total net change in cash and cash equivalents for the six months ended January 31, 2007 was a decrease of \$0.4 million. The primary uses of cash during the six months ended January 31, 2007 included \$2.9 million for purchases of property and equipment and approximately \$2.8 million in repayments on notes payable and capital lease obligations. Our primary sources of cash during the six months ended January 31, 2007 were \$2.6 million of cash generated from operating activities, \$1.0 million in proceeds from exercise of stock options and warrants and \$1.8 million in proceeds from note payable. Net cash generated from operating activities of \$2.6 million during the six months ended January 31, 2007, resulted primarily from non-cash charges of approximately \$10.0 million, which was partially offset by funding our \$6.5 million net loss and \$1.0 million of net changes in operating assets and liabilities.

Our revolving credit facility with Silver Point allows for maximum borrowing of \$3.0 million and expires on April 11, 2011. Outstanding amounts will bear interest at either: (a) 7% per annum plus, the greater of (i) Prime Rate, and (ii) the Federal Funds Effective Rate plus 3%, or (b) 8% plus the floating rate of LIBOR. Interest is payable in arrears on the last day of the month for Base Rate loans, and the last day of the chosen interest period (one, two or three months) for LIBOR Rate loans. During the second quarter of fiscal year 2007, we borrowed and repaid \$1.0 million under the revolving credit facility.

Our revolving credit facility with Atlantic Investors LLC allows for maximum borrowing of \$5.0 million. All outstanding amounts under the Atlantic facility shall be paid in full no later than the date that is 90 days after the earlier of: (a) April 11, 2011, and (b) the date all obligations under the Silver Point Credit Facility have been paid in full. Credit advances under the Atlantic facility shall bear interest at either: (a) 7% per annum plus the greater of (i) Prime Rate, and (ii) the Federal Funds Effective Rate plus 3%, or (b) 8% plus the floating rate of LIBOR. Interest may, at our option, be paid in cash or promissory notes. As of January 31, 2007, we had not started borrowing from our facility with Atlantic Investors LLC.

Given the Company's cash resources as of January 31, 2007 and committed lines of credit, the Company believes that it has sufficient liquidity to support its operations over the fiscal year and for the foreseeable future.



**Table of Contents****Recent Accounting Pronouncements**

In February 2007, the Financial Accounting Standards Board ( FASB ) issued Statement of Financial Accounting Standards No. 159 ( FAS 159 ), The Fair Value Option for Financial Assets and Liabilities . FAS 159 permits entities to choose to measure many financial instruments and certain other items at fair value. FAS 159 will be effective for the Company s fiscal year beginning August 1, 2008. Early adoption is permitted. The Company has not determined the impact, if any, that adopting this standard may have on its consolidated financial position or results of operations.

In September 2006, the Securities and Exchange Commission ( SEC ) issued Staff Accounting Bulletin No. 108 ( SAB 108 ) which provides interpretive guidance on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a current year misstatement. SAB 108 is effective for fiscal years ending after November 15, 2006. We are currently evaluating the effect, if any, that this pronouncement will have on our financial results.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements ( FAS 157 ). FAS 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. The provisions of FAS 157 are effective for fiscal years beginning after November 15, 2007. The Company is currently evaluating the impact of the provisions of FAS 157.

In June 2006, the Emerging Issues Task Force ( EITF ) reached a consensus on EITF 06-3, How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement . EITF 06-3 provides that taxes imposed by a governmental authority on a revenue producing transaction between a seller and a customer should be shown in the income statement on either a gross or a net basis, based on the entity s accounting policy, which should be disclosed pursuant to APB Opinion No. 22, Disclosure of Accounting Policies. If such taxes are significant, and are presented on a gross basis, the amounts of those taxes should be disclosed. EITF 06-3 must be applied to financial reports for interim and annual reporting periods beginning after December 15, 2006. We are currently evaluating the impact EITF 06-3 will have on the presentation of our consolidated financial statements.

In June 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes ( FIN 48 ). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in the Company s financial statements in accordance with FASB Statement No. 109, Accounting for Income Taxes. The provisions of FIN 48 are effective for fiscal years beginning after December 15, 2006. We are currently evaluating the impact the provisions of FIN 48 will have on our financial results.

In February 2006, the FASB issued SFAS No. 155, Accounting for Certain Hybrid Financial Instruments an amendment of FASB Statements No. 133 and 140 . SFAS No. 155 (1) permits fair value re-measurement for any hybrid financial instrument that contains an embedded derivative that would otherwise require bifurcation, (2) clarifies which interest-only strips and principal-only strips are not subject to the requirements of FASB Statement No. 133, (3) establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an imbedded derivative requiring bifurcation, (4) clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives, and (5) amends FASB Statement No. 140 to eliminate the prohibition on a qualifying special-purpose entity from holding a derivative financial instrument that pertains to a beneficial interest in other than another derivative financial instrument. SFAS No. 155 is effective August 1, 2007 and we are currently evaluating the effect, if any, that this pronouncement will have on our future financial results.

**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 January 31, 2007, are as follows:

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| Description                         | Total      | Less      | 1-3            | 4-5 Year  | After     |
|-------------------------------------|------------|-----------|----------------|-----------|-----------|
|                                     |            | than      |                |           |           |
|                                     |            | 1 Year    | (In thousands) |           |           |
| Short/Long-term debt <sup>(a)</sup> | \$ 78,304  | \$ 10,825 | \$ 18,437      | \$ 49,042 | \$        |
| Interest on debt <sup>(b)</sup>     | 34,692     | 9,028     | 15,656         | 10,008    |           |
| Capital leases                      | 3,102      | 2,469     | 556            | 77        |           |
| Bandwidth commitments               | 1,866      | 1,506     | 360            |           |           |
| Maintenance for hardware/software   | 372        | 366       | 6              |           |           |
| Property leases <sup>(c)(d)</sup>   | 54,672     | 10,153    | 15,590         | 7,614     | 21,315    |
|                                     | \$ 173,008 | \$ 34,347 | \$ 50,605      | \$ 66,741 | \$ 21,315 |

(a) *Short/Long-term debt does not tie to the Condensed Consolidated Balance Sheets due to recorded discounts for warrants and embedded derivative.*

(b) *Interest on Term Loan assumes LIBOR is fixed at 5.36%.*

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

(d) *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.*

#### **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 United States of America. 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 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 and impairment of long-lived assets. Management reviews the 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.* Revenue consists primarily of monthly fees for Web site and Internet application management, hosting, colocation and professional services. We also derive revenue from the sale of software and related maintenance contracts. Reimbursable expenses charged to customers are included in revenue and cost of revenue. Application management, hosting and colocation revenue is billed and recognized over the term of the contract, generally one to three years, based on actual usage. Installation fees associated with application management, hosting and colocation revenue are billed at the time the installation service is provided and recognized over the term of the related contract. Payments received in advance of providing services are deferred until the period such services are provided. Revenue from professional services is recognized on either a time and material basis as the services are performed or under the percentage of completion method for fixed price contracts. 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 costs of the contract exceed the estimated revenue that will be generated by the contract. Unbilled accounts receivable represents 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. Revenue from the sale of software is recognized when persuasive evidence of an arrangement exists, the product has been delivered, the fees are fixed and determinable and collection of the resulting receivable is reasonably assured. In instances where we also provide application management and hosting services in conjunction with the sale of software, software revenue is deferred and recognized ratably over the expected customer relationship period. If we determine that collection of a fee is not reasonably assured, we defer the fee and recognize revenue at the time collection becomes reasonably assured,

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which is generally upon receipt of cash.

Existing customers are subject to ongoing credit evaluations based on payment history and other factors. If it is determined subsequent to our initial evaluation and at any time during the arrangement that collectability is not reasonably assured, revenue is recognized as cash is received. Due to the nature of our service arrangements, we provide written notice of termination of services, typically 10 days in advance of disconnecting a customer. Revenue for services rendered during this notification period is generally recognized on a cash basis as collectability is not considered probable at the time the services are provided.

*Allowance for Doubtful Accounts.* We perform 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 receivables 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, current economic trends and changes in our customer 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 and 2% of all other customer balances. 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.

*Impairment of Long-lived Assets.* We review our long-lived assets, subject to amortization and depreciation, including customer lists and property and equipment, for impairment whenever events or changes in circumstances indicate that the carrying amount of these assets may not be recoverable. Factors we consider important that could trigger an interim 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
- our market capitalization relative to net book value.

Recoverability is measured by a comparison of the carrying amount of an asset to future undiscounted cash flows expected to be generated by the asset. If the assets were considered to be impaired, the impairment to be recognized would be measured by the amount by which the carrying value of the assets exceeds their fair value. Fair value is determined based on discounted cash flows or appraised values, 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. Intangible assets consist of customer lists.

We review the valuation of our goodwill in the fourth quarter of each fiscal year. If an event or circumstance indicates that it is more likely than not an impairment loss has been incurred, we review the valuation of goodwill on an interim basis. An impairment loss is recognized to the extent that the carrying amount of goodwill exceeds its implied fair value. Impairment losses are recognized in operations.

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

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 term loan facility with Silver Point Finance, we are required to have interest rate protection which shall effectively limit the unadjusted LIBOR component of the interest costs of our loan with respect to not less than 70% of the principal amount at a rate not more than 6.5% per annum. Our exposure to market risk associated with risk-sensitive instruments entered into for purposes other than trading purposes is not material to us. We currently have no significant foreign operations and therefore face no material foreign currency



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exchange rate risk. Our interest rate risk at January 31, 2007 was limited mainly to LIBOR on our outstanding loan with our senior secured term loan facility with Silver Point Finance. At January 31, 2007 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 \$0.2 million increase in our interest expense under our senior secured term loan facility with Silver Point Finance for the fiscal quarter ended January 31, 2007.

**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 Exchange Act) 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 Exchange Act) 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**

On or about June 13, 2001, Stuart Werman and Lynn McFarlane filed a lawsuit against us, BancBoston Robertson Stephens, an underwriter of our initial public offering in October 1999, Joel B. Rosen, our then chief executive officer, and Kenneth W. Hale, our then chief financial officer. The suit was filed in the United States District Court for the Southern District of New York, and generally alleges that the defendants violated federal securities laws by not disclosing certain actions allegedly taken by Robertson Stephens in connection with our initial public offering. The suit 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. Four other substantially similar lawsuits were filed between June 15, 2001 and July 10, 2001 by Moses Mayer (filed June 15, 2001), Barry Feldman (filed June 19, 2001), David Federico (filed June 21, 2001) and Binh Nguyen (filed July 10, 2001). Robert E. Eisenberg, our president at the time of the initial public offering in 1999, was named as a defendant in the Nguyen lawsuit. The Federico lawsuit sought certification of a plaintiff class consisting of all persons who acquired shares of our common stock between October 22, 1999 and June 12, 2001, and also named additional underwriter defendants, including J. P. Morgan Chase, First Albany Companies, Inc., Bank of America Securities, LLC, Bear Stearns & Co., Inc., B. T. Alex. Brown, Inc., Chase Securities, Inc., CIBC World Markets, Credit Suisse First Boston Corp., Dain Rauscher, Inc., Deutsche Bank Securities, Inc., The Goldman Sachs Group, Inc., J. P. Morgan & Co., J. P. Morgan Securities, Lehman Brothers, Inc., Merrill Lynch, Pierce, Fenner & Smith, Inc., Morgan Stanley Dean Witter & Co., Robert Fleming, Inc. and Salomon Smith Barney, Inc.

Those five cases, along with lawsuits naming more than 300 other issuers and over 50 investment banks which have been sued in substantially similar lawsuits, have been assigned to the Honorable Shira A. Scheindlin (the Court) for all pretrial purposes (the IPO Securities Litigation). On September 6, 2001, the Court entered an order consolidating the five individual cases involving us and designating Werman v. NaviSite, Inc., et al., Civil Action No. 01-CV-5374 as the lead case. A consolidated, amended complaint was filed thereafter on April 19, 2002 (the Class Action Litigation) on behalf of plaintiffs Arvid Brandstrom and Tony Tse 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. Plaintiffs uniformly allege that all defendants, including the

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NaviSite Defendants, violated the federal securities laws (i.e., Sections 11 and 15 of the Securities Act, Sections 10(b) and 20(a) of the Exchange Act and Rule 10b-5) by issuing and selling our common stock pursuant to the October 22, 1999 initial public offering, without disclosing to investors that some of the underwriters of the offering, including the lead underwriters, had solicited and received extensive and 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. At this time, plaintiffs have not specified the amount of damages they are seeking in the Class Action Litigation.

Between July and September 2002, the parties to the IPO Securities Litigation briefed motions to dismiss filed by the underwriter defendants and the issuer defendants, including NaviSite. On November 1, 2002, the Court held oral argument on the motions to dismiss. The plaintiffs have since agreed to dismiss the claims against Messrs. Rosen, Hale and Eisenberg without prejudice, in return for their agreement to toll any statute of limitations applicable to those claims. By stipulation entered by the Court on November 18, 2002, Messrs. Rosen, Hale and Eisenberg were dismissed without prejudice from the Class Action Litigation. On February 19, 2003, an opinion and order was issued on defendants' motion to dismiss the IPO Securities Litigation, essentially denying the motions to dismiss of all 55 underwriter defendants and of 185 of the 301 issuer defendants, including NaviSite.

On June 30, 2003, our Board of Directors considered and authorized us to negotiate a settlement of the pending Class Action Litigation substantially consistent with a memorandum of understanding negotiated among proposed class plaintiffs, the issuer defendants and the insurers for such issuer defendants. Among other contingencies, any such settlement would be subject to approval by the Court. Plaintiffs filed on June 14, 2004, a motion for preliminary approval of the Stipulation And Agreement Of Settlement With Defendant Issuers And Individuals (the Preliminary Approval Motion). On February 15, 2005, the Court approved the Preliminary Approval Motion in a written opinion which detailed the terms of the settlement stipulation, its accompanying documents and schedules, the proposed class notice and, with a modification to the bar order to be entered, the proposed settlement order and judgment. A further conference was held on April 13, 2005, at which time the Court considered additional submissions but did not make final determinations regarding the exact form, substance and program for notifying the proposed settlement class. On August 31, 2005, the Court entered a further Preliminary Order in Connection with Settlement Proceedings (the Preliminary Approval Order), which granted preliminary approval to the issuer's settlement with the plaintiffs in the IPO Securities Litigation. The Court subsequently held a Fed. R. Civ. P. 23 fairness hearing on April 24, 2006 in order to consider the written and oral submissions addressing whether the Court should enter final approval of the settlement. On November 15, 2006, a second amendment to the settlement stipulation was filed (Amendment # 2). Amendment #2 modifies how the Recovery Deficit, as defined in the settlement stipulation, is to be calculated and also deletes certain provisions pursuant to which the insurers could have recouped certain Notice Costs, Litigation Trust Costs and Defense Costs as defined in the settlement stipulation. The matter was taken under advisement and remains pending with the Court.

On October 13, 2004, the Court granted a contested motion for class certification in a sub-group of cases consolidated in the IPO Securities Litigation. On December 5, 2006, a panel of the United States Court of Appeals for the Second Circuit (the Second Circuit) issued an opinion vacating the Court's class certification decision because, among others, the plaintiffs-appellees therein could not satisfy the predominance requirement for a Fed. R. Civ. P. 23(b)(3) class action. On January 5, 2007, the plaintiffs-appellees filed a petition with the Second Circuit for rehearing and rehearing en banc (the Petition). In response to a January 24, 2007 order by the Second Circuit, on February 7, 2007, defendants-appellants filed a response to the Petition. The Petition remains pending in the Second Circuit. Absent modification by or further proceedings in the Second Circuit, the matter is to be remanded to the Court for further proceedings. The effect, if any, of the Second Circuit's ruling on the pending issuers' settlement is not known at this time.

If the proposed issuers' settlement is completed and then approved by the Court without further modifications to its material terms, we and the participating insurers acting on our behalf may be responsible for providing funding of approximately \$3.4 million towards the total amount plaintiffs are guaranteed by the proposed issuer's settlement to recover in the IPO Securities Litigation. The amount of the guarantee allocable to us could be reduced or eliminated in



its entirety in the event that plaintiffs are able to recover some or all of the total amount of such overall guarantee from settlements with or judgments obtained against the non-settling defendants. Even if no additional recovery is

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obtained from any of the non-settling defendants, the settlement amount allocable to us is expected to be fully covered by our existing insurance policies and is not expected to have a material effect on our business, financial condition, results of operations or cash flows.

We believe that the allegations against us are without merit and, if the settlement is not approved by the Court and finalized, 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.

**Item 1A. Risk Factors**

In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part I, Item 1A. Risk Factors in our Annual Report on Form 10-K for the fiscal year ended July 31, 2006, which could materially affect our business, financial condition or future results. The risks described 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. Other than with respect to the risk factors below, there have been no material changes from the risk factors disclosed in our Annual Report on Form 10-K. The risk factors below were disclosed on our Annual Report on Form 10-K and have been updated as of January 31, 2007.

**We have a history of losses and may never achieve or sustain profitability.**

We have never been profitable and may never become profitable. As of January 31, 2007, we had incurred losses since our incorporation resulting in an accumulated deficit of approximately \$476.3 million. During the fiscal quarter ended January 31, 2007, we had a net loss of approximately \$3.8 million. We anticipate that we will continue to incur net losses in the future. As a result, we can give no assurance that we will achieve profitability or be capable of sustaining profitable operations.

**A significant portion of our revenue comes from one customer and, if we lost this customer, it would have a significant adverse impact on our business results and cash flows.**

The New York State Department of Labor represented approximately 8% of our consolidated revenue for the six months ended January 31, 2007 and 2006, respectively. We have multiple projects and services covered under our contract with the New York State Department of Labor. For the fiscal quarter ended January 31, 2007, services relating to the America's Job Bank program represented approximately 6% of our consolidated revenue from the New York State Department of Labor, and projects and services relating to the America's One Stop Operating System program represented approximately 2% of our consolidated revenue from the New York State Department of Labor.

On August 16, 2005, we entered into an agreement with the New York State Department of Labor with a two year term which is set to expire on June 14, 2007. We have been notified by the New York State Department of Labor that funding for the America's Job Bank program will cease at the expiration of our current contract. We have begun making preparations to continue the program and service it without government funding and expect to receive revenues from advertising placement as well as other ancillary services, but we cannot assure you that revenue will remain at the same level or that cash flows will not be adversely impacted.

**Atlantic Investors, LLC, Unicorn Worldwide Holdings Limited and Madison Technology LLC may have interests that conflict with the interests of our other stockholders and, as the owners of a majority of our common stock, can prevent new and existing investors from influencing significant corporate decisions.**

Atlantic Investors, LLC and Unicorn Worldwide Holdings Limited and Madison Technology LLC, Atlantic Investors' two managing members, together owned approximately 50.1% of our outstanding capital stock as of February 27, 2007. Following the closing of our senior secured term loan facility with Silver Point Finance, LLC on April 11, 2006, Atlantic Investors' ownership alone was approximately 43% on a fully diluted basis. In addition on January 2, 2007, Atlantic Investors converted a promissory note with principal and accrued interest of approximately \$3.9 million into 1,374,950 shares of our common stock to sell in an offering of shares of our

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common stock by certain selling stockholders pursuant to a registration statement on Form S-3 filed on November 28, 2006.

Atlantic Investors, LLC, Unicorn Worldwide Holdings Limited and Madison Technology LLC together have the power to elect a majority of our Board of Directors and have the ability to control our management and affairs and determine the outcome of any corporate action requiring stockholder approval. Regardless of how our other stockholders may vote, Atlantic Investors, Unicorn Worldwide Holdings and Madison Technology acting together have the ability to determine whether to engage in a merger, consolidation or sale of our assets and any other significant corporate transaction. Under Delaware law, Atlantic Investors, Unicorn Worldwide Holdings and Madison Technology are able to exercise their voting power by written consent, without convening a meeting of the stockholders. The ownership of a majority of our outstanding common stock by Atlantic Investors, Unicorn Worldwide Holdings and Madison Technology may have the effect of delaying, deterring or preventing a change in control of us or discouraging a potential acquirer from attempting to obtain control of us, which could adversely affect the market price of our common stock.

**Item 4. Submission of Matters to a Vote of Security Holders**

At the 2006 Annual meeting of Stockholders of the Company (the Annual Meeting ) held on December 12, 2006, the following matters were acted upon by the stockholders of the Company:

1. The election of six members of the board of directors of the Company to serve for a one-year term; and
2. Ratification of the appointment of KPMG LLP as the independent registered public accounting firm of the Company for the current fiscal year.

The number of shares of Common Stock issued, outstanding and eligible to vote as of the record date of October 23, 2006 was 29,065,200. The results of the voting on each of the matters presented to stockholders at the Annual Meeting are set forth below:

|   | <b>Votes For</b> | <b>Votes Withheld</b> | <b>Votes Against</b> | <b>Abstentions</b> | <b>Broker Non-Votes</b> |
|---|------------------|-----------------------|----------------------|--------------------|-------------------------|
| Election of six members of the board of Directors:      |                  |                       |                      |                    |                         |
| Andrew Ruhan  | 23,581,556       | 15,746                | N/A                  | N/A                | N/A                     |
| Arthur P. Becker  | 23,579,962       | 17,340                | N/A                  | N/A                | N/A                     |
| Gabriel Ruhan   | 23,579,180       | 18,122                | N/A                  | N/A                | N/A                     |
| James Denedy  | 23,589,031       | 8,271                 | N/A                  | N/A                | N/A                     |
| Larry Schwartz  | 23,587,642       | 9,660                 | N/A                  | N/A                | N/A                     |
| Thomas R. Evans   | 23,587,831       | 9,471                 | N/A                  | N/A                | N/A                     |
| Ratification of Independent Registered Accounting Firm: | 23,591,338       | N/A                   | 5,348                | 616                | 0                       |

**Item 5. Other Information**

During the quarter ended January 31, 2007, 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.

March 14, 2007

NAVISITE, INC.

By: /s/ James W. Pluntze

James W. Pluntze  
(Principal Financial and Accounting  
Officer)

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**EXHIBIT INDEX**

| <b>Exhibit<br/>Number</b> | <b>Description</b>  |
|---------------------------|---|
| 10.1                      | Amendment No. 1 to Credit and Guaranty Agreement, dated June 2, 2006, by and among the Registrant, the subsidiaries of the Registrant, the Lenders and Silver Point Finance, LLC.   |
| 10.2                      | Amendment No. 2 to Credit and Guaranty Agreement, dated September 26, 2006, by and among the Registrant, the subsidiaries of the Registrant, the Lenders and Silver Point Finance, LLC.   |
| 10.3                      | Amendment No. 3 to Credit and Guaranty Agreement, dated January 5, 2007, by and among the Registrant, the subsidiaries of the Registrant, the Lenders and Silver Point Finance, LLC.  |
| 10.4                      | Amendment No. 4 to Credit and Guaranty Agreement, dated February 13, 2007, by and among the Registrant, the subsidiaries of the Registrant, the Lenders and Silver Point Finance, LLC.  |
| 10.5                      | Warrant Purchase Agreement, dated as of February 13, 2007, by and among the Registrant, SPCP Group, LLC and SPCP Group III, LLC is incorporated herein by reference to Exhibit 10.1 of the Registrant's Current Report on Form 8-K filed on February 20, 2007 (File No. 000-27597). |
| 10.6                      | Warrant to Purchase Common Stock, dated February 13, 2007, issued by the Registrant to SPCP Group, LLC is incorporated herein by reference to Exhibit 10.2 of the Registrant's Current Report on Form 8-K filed on February 20, 2007 (File No. 000-27597).                          |
| 10.7                      | Warrant to Purchase Common Stock, dated February 13, 2007, issued by the Registrant to SPCP Group III, LLC is incorporated herein by reference to Exhibit 10.3 of the Registrant's Current Report on Form 8-K filed on February 20, 2007 (File No. 000-27597).                      |
| 10.8                      | Amendment No. 1 to Warrant, dated as of February 13, 2007, by and between the Registrant and SPCP Group, LLC.   |
| 10.9                      | Waiver and Extension to Credit and Guaranty Agreement, dated as of November 28, 2006, by and among the Registrant, the subsidiaries of the Registrant, the lenders and Silver Point Finance LLC.  |
| 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.  |