

NAVISITE INC
Form 10-K
October 29, 2002
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

FOR ANNUAL AND TRANSITIONAL REPORTS PURSUANT TO SECTIONS 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

(Mark One)

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

For the fiscal year ended July 31, 2002

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: 0-27597

NAVISITE, INC.

(Exact name of registrant as specified in its charter)

Delaware
(State or other
jurisdiction of incorporation)

400 Minuteman Road
Andover, Massachusetts
(jurisdiction of incorporation)

52-2137343
(I.R.S. Employer
Identification No.)

01810
(Zip Code)

(978) 682-8300
(Registrant's telephone number, including area code)

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 than the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ☒ No ☐

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Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. x

The aggregate market value of the registrant's common stock, \$0.01 par value per share, held by non-affiliates of the registrant was approximately \$3,707,334, based on the last reported sale price of the registrant's common stock on the Nasdaq SmallCap Market as of the close of business on October 25, 2002.

As of October 25, 2002 there were 95,610,362 shares outstanding of the registrant's common stock, par value \$0.01 per share.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's definitive proxy statement for its annual meeting of stockholders for the fiscal year ended July 31, 2002, which will be filed with the Securities and Exchange Commission within 120 days after the end of the registrant's fiscal year, are incorporated by reference into Part III hereof.

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PART I

Special Note Regarding Forward-Looking Statements

This Form 10-K contains forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934, 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 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 reissue these forward-looking statements to reflect events or circumstances that arise after the date hereof.

Item 1. Business

Company Overview

NaviSite, Inc. (NaviSite) provides outsourced Web hosting and managed application services for companies conducting mission critical business on the Internet, including enterprises and other businesses deploying Internet applications. Our goal is to help customers focus on their core competencies by outsourcing the management and hosting of their Web operations and applications, allowing customers to fundamentally improve the efficiency of their Web operations. We also provide related professional and consulting services. Our focus on enhanced management services, beyond basic co-location and infrastructure services, allows us to meet the expanding needs of businesses as their Web sites and Internet applications become more complex.

We provide Always On Managed HostingSM and we believe that there are a relatively small number of companies that combine a highly scalable and developed infrastructure with expertise, experience, intellectual property, software platforms, processes and procedures for delivering complex managed hosting services. We define Always On Managed HostingSM as a combination of high availability infrastructure, high performance monitoring systems and proactive problem resolution and change management processes designed to recognize patterns and identify and address potentially crippling problems before they are able to cause downtime in customers' Web operations. The price for our services varies from customer to customer based on the number of managed servers and the nature, extent and level of services provided.

We derive our revenue primarily from managed hosting services, but within that framework, from a variety of service offerings, including:

Managed Applications for customers who want to outsource the end-to-end management of their packaged or custom e-business application.

Managed Servers for customers who intend to manage the application, but want to outsource the management of the infrastructure software OS, web servers, database servers, application servers and integration and transaction processing middleware to a trusted third party.

Managed Infrastructure for customers who want to be able to select value added security, network, application load balancing, storage, advanced backup and recovery services on an a la carte basis, knowing that they are designed to be used either alone or together.

Managed Facilities for customers with significant internal IT resources but who want a vendor to manage the underlying data center and bandwidth facilities.

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Expertise Services for customers who want to leverage industry experts for specialized services including solutions architecture, data center migration, application and infrastructure consolidation and scalability testing that address their unique business needs.

NaviSite was incorporated in Delaware in December 1998 and is a 79.6% owned subsidiary of ClearBlue Technologies, Inc. (ClearBlue). Prior to September 11, 2002, we were a 75.8% owned subsidiary of CMGI, Inc. (CMGI). Since January 31, 2000, our corporate headquarters have been located at 400 Minuteman Road, Andover, Massachusetts. Additionally, we operate two state of the art data centers, one in Andover, Massachusetts and one in San Jose, California.

Fiscal 2002 Operating Plan and Recent Developments

Fiscal year 2002 has been a challenging year for the technology industry and the telecommunications and IT services market, in particular. In fiscal year 2002, we executed a plan to restructure our business model and our business operations. Over the course of the year, we raised new financing, restructured our operating leases and fixed cost infrastructure contracts to significantly reduce excess capacity, implemented labor efficiencies, managed out non-productive customers, eliminated low margin product lines, and divested a non-core business. As a result, we have reduced our revenue requirement for EBITDA (we define EBITDA as earnings before interest, tax, depreciation and amortization, including the amortization of the beneficial conversion feature of our convertible debt) break-even from \$44 million per quarter at July 31, 2001 to \$11 million per quarter at July 31, 2002, while improving the quality of our service delivery, customer satisfaction and our publicly available and industry leading operating metrics.

During fiscal year 2002, we systematically reduced our run rate cash burn from \$7.3 million per month in the fourth quarter of fiscal year 2001 to \$1.4 million per month in the fourth quarter of fiscal year 2002. Further, as we have shifted our business model away from a return on our physical infrastructure to one focused on generating a return on our managed services platform, such as IP, software infrastructure and work processes, we expect to leverage the capital investments already made without significant new capital requirements going forward.

HPFS/CMGI Financing

Under the terms of an agreement dated October 29, 2001, NaviSite received a total of \$65 million in financing from Compaq Financial Services Corporation, a wholly owned subsidiary of Compaq Computer Corporation and now known as Hewlett-Packard Financial Services Company (HPFS), and CMGI. We received \$20 million and \$10 million in cash from HPFS and CMGI, respectively, in the form of notes payable (collectively, the Convertible Notes) with interest payable in the first three years and principal and interest payable thereafter. We also purchased certain equipment previously under operating leases for approximately \$35 million.

Also in connection with this agreement, CMGI converted its existing \$80 million in outstanding notes due in December 2003 into approximately 14.5 million shares of our common stock and approximately \$16.2 million of amounts due to CMGI were converted into approximately 9.9 million shares of our common stock.

Restructured Operating Leases and Infrastructure Contracts

Operating Leases. At the beginning of fiscal year 2002, NaviSite had \$82 million in assets under operating leases with third parties and an additional \$23 million under operating leases held by CMGI but used by NaviSite. A portion of this equipment became undeployed during fiscal year 2002 and was not being utilized.

In fiscal year 2002, we renegotiated, restructured or bought out \$73.6 million in NaviSite operating assets comprised of 199 leases with seven different lessors. In conjunction with these transactions, we returned

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\$5.6 million of equipment, paid approximately \$7.6 million in one time cash payments and took asset impairment charges of \$30.2 million as the equipment was marked to fair market value. The impact on the business was a significant reduction in operating lease payments from \$44.5 million in fiscal year 2001 to \$8.3 million in fiscal year 2002. Going forward, the contractual operating lease commitments in fiscal year 2003 will be approximately \$1.9 million.

The \$23 million in CMGI leased equipment utilized by NaviSite has been returned to CMGI in conjunction with a settlement agreement executed on August 19, 2002. As part of the settlement agreement with CMGI, we settled a net liability to CMGI of \$7.7 million for \$3.2 million in cash, which was paid in August 2002.

Bandwidth. NaviSite deploys a N+1 bandwidth architecture with direct private transit Internet connections into multiple major Internet backbone providers, thereby increasing speed, reliability and consistency of performance for our customers' Internet applications. We believe this differentiates our network infrastructure from those of our competitors.

In fiscal year 2002, we executed an aggressive cost reduction plan that both eliminated overall excess capacity and lowered unit bandwidth costs. We actively renegotiated two major bandwidth contracts and concurrently brought in three additional providers under monthly or pure usage based contracts with minimal usage commitments. As a result, overall bandwidth expenses in fiscal year 2002 were down 62% from fiscal year 2001 and fully loaded unit costs decreased by 45% in fiscal year 2002 compared with the prior fiscal year. Making changes to our bandwidth architecture, providers and contracts require long lead times. Consequently, we expect to fully realize the economic benefits of these actions in fiscal year 2003 when overall bandwidth expenses will be reduced by 83% from fiscal year 2001 and fully loaded unit costs will be reduced by 67% over fiscal year 2001.

Finally, another significant outcome of our cost reduction plan is that minimum contracted bandwidth commitments have been dramatically reduced. For fiscal year 2002, minimum contracted bandwidth payments were \$3.6 million versus \$9.5 million in fiscal year 2001. In fiscal year 2003, our minimum committed bandwidth payments are approximately \$937,000.

Maintenance. NaviSite has maintenance contracts with various providers for 24x7 support of all infrastructure, equipment, software and data center facilities. In fiscal year 2001, NaviSite entered into multiple, long-term maintenance support contracts with significant minimum volume commitments. These volume commitments were driven by expected growth and market analysis. When this growth did not materialize, we incurred maintenance expenses for idle software and hardware assets.

In fiscal year 2002, we renegotiated, downsized or bought out approximately 70% of our maintenance contracts. Each of our restructured maintenance contracts now has a usage-based clause that allows us to adjust volumes monthly or quarterly, which gives us flexibility without the minimum commitments. Concurrently, we consolidated infrastructure and network architectures to increase utilization and further drive cost savings. In fiscal year 2002, we reduced our maintenance expenses by 20% over fiscal year 2001. The majority of the annualized savings will be realized in fiscal year 2003 when we expect an additional 44% savings over fiscal year 2002, assuming current volume.

Labor and Operating Efficiencies

In fiscal year 2002 we aggressively restructured our organization and implemented labor efficiencies across the entire organization. As a result, overall labor and consulting expenses in fiscal year 2002 were approximately \$36 million, down from \$80 million in fiscal year 2001.

Examples of these efficiencies include the following: In the area of customer service, we consolidated what were previously two organizations that interacted with the customer into one integrated account management

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function. This increased the quality of customer service, increased solutions up-selling and reduced costs. In operations, we consolidated end-to-end service responsibility into an integrated service delivery organization. Additionally, our investments in automation combined with the maturation of our software and management systems allowed us to refine our work processes and further drive efficiencies. In research and development, we focused on a much more narrow set of initiatives with near term return on investments. We tracked and managed sales force and marketing productivity and we gained administrative efficiencies through consolidating functions.

The effectiveness of our actions is best measured by the steady and systematic improvements in the quality of the services delivered to our customer base. We believe we are currently the only managed services provider to make our monthly operating metrics publicly available on a monthly basis. These objective measures ensure transparency into our operations. There are three metrics we report: (1) mean time to notify a customer of an incident, which improved 57% from an average of 10.03 minutes in fiscal year 2001 to 4.32 minutes in fiscal year 2002; (2) mean time to respond, which is the time it takes to get an engineer to resolve an issue, improved 60% from 20.08 minutes in fiscal year 2001 to 8.01 minutes in fiscal year 2002; and (3) overall site availability, which was 99.999% in both fiscal year 2001 and 2002.

Going forward, we will continue to look for areas of improvement, to re-evaluate staffing levels and to implement additional labor efficiencies as we deem appropriate.

Data Center and Real Estate Consolidation

At the end of fiscal year 2001, we made the decision to consolidate two first generation data centers into our two second generation data center facilities. We completed the customer migration with no downtime to our customers and we completed the consolidation in the third quarter of fiscal year 2002 ahead of schedule and \$2.5 million under budget.

At our Andover facility, NaviSite leases both office and data center space. Subsequent to the fiscal year end, we had been in negotiations with our Andover landlord to buy-out the office space portion of the lease. The terms are described under Item 2 Properties. Contingent upon receiving consent from the mortgage company, we intend to execute this transaction. The transaction is expected to be operating cash flow break-even in approximately 15 months and is expected to result in \$1.8 million in annual savings for the remaining nine years and two months of the lease.

Product Lines

Last fall, we made a decision to sell our Streaming Media Division. The Streaming Media Division was cash flow negative, faced a difficult competitive market and was non-core to our overall strategy. On March 21, 2002, we sold certain Streaming Media Division assets to SMC Corporation and discontinued our streaming service offerings. We received proceeds of approximately \$1.6 million in cash and entered into a sublease of our La Jolla, California facility for approximately \$700,000 to be paid over two years to cover the cost of the facilities.

During the second quarter of fiscal year 2002, we made the decision to discontinue our practice, on a prospective basis, of obtaining equipment under lease arrangements and subsequently renting the equipment to our customers. The decision was made for three reasons. First, it is a low margin business and we can continue to service our customers as the single point of procurement and management without assuming the lease or title to the equipment. Second, many of our enterprise customers can acquire hardware equipment with a lower cost of capital. Third, it eliminates additional credit and financial risk associated with an early customer contract termination. While this decision is expected to improve overall margins, it will reduce revenue potential from future customers and impact overall revenues as existing equipment leases terminate and are not renewed or when existing customers renew their contracts and enter into a direct finance relationship with NaviSite for their equipment. Revenue from equipment rental accounted for approximately 22% in fiscal year 2002 compared with 25% in fiscal year 2001.

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On October 18, 2002, we eliminated our practice of re-selling Akamai's content delivery network (CDN) services. We have entered into a new referral relationship with Akamai whereby we will expand our offerings to include the full Akamai EdgeSuite product line and continue to service our customers as a single point of management. Although we will no longer recognize revenues from the resale of CDN services, we expect that this decision will improve margins and eliminate approximately \$500,000 in minimum annual commitments.

Implementation of Revised Business Model

Over the past few quarters, we have been evaluating a business model whereby we would provide integrated managed hosting services in data centers owned by third parties in addition to our own data centers. We believe that this approach would augment our existing management expertise, software and operating processes by increasing distribution and geographic reach. In fact, subsequent to the fiscal year end, we publicly launched our remote management services in which we delivered our application management services in customer locations and third-party data centers. This approach is consistent with our overall shift in focus from generating returns on physical infrastructure to generating returns on our managed services platform. In conjunction with our decision to exit the equipment rental business, we believe this change in our business model will result in a higher quality of revenue, improved overall margins and strengthened strategic position in the marketplace.

As part of our accounting procedures at July 31, 2002, we evaluated the impairment of long lived assets. It was determined that certain assets were impaired and we realized an impairment charge of \$38.1 million in fiscal year 2002.

Managing the Customer Base

Over the course of fiscal year 2002, we had proactively managed out non-productive and unprofitable customers. At the end of fiscal year 2001, 67% of our customer base was concentrated in small start-up Internet based businesses and independent software vendors (ISVs). Many of these customers experienced difficulty with their business models and have gone out of business over the course of the past year. Our overall customer count has decreased from 288 customers at July 31, 2001 to approximately 145 customers at July 31, 2002. Further, the bad debt expense has decreased from \$11.9 million in fiscal year 2001 to \$3.5 million in fiscal year 2002. Equally, accounts receivable days sales outstanding have correspondingly improved from 56 days in the fourth quarter of fiscal year 2001 based on the collectibility method, to 44 days in the fourth quarter of fiscal year 2002. We believe these statistics are indications of a healthier and much more stable customer base.

Over the past year, we have focused on strengthening our relationships with key customers. In addition to moving to a customer relationship management model within a customer support organization, we now provide all customers with monthly performance summaries, perform quarterly account reviews with approximately 80% of our customers, and we perform system health checks and application audits either annually or semi-annually where we meet with customers in person to review their technology solutions and upcoming needs.

New Revenue Growth through Channels

In fiscal year 2002, we focused on building and delivering customized enterprise solutions with system integration partners who perform the implementation and manage the customer specific content. We launched managed Oracle 11i business applications with four regional system integration firms and two large national consulting firms. Additionally, we recently launched a channel partnership with Progress Software Corporation where we are working together to enable their base of ISVs to provide their software as a service, known as application service provider or ASP.

New Majority Stockholder

On September 11, 2002, each of CMGI and HPFS sold and transferred all of their respective equity and debt interests in NaviSite to ClearBlue. As a result of these transactions, ClearBlue owns, directly or indirectly through

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its wholly owned subsidiaries, approximately 79% of the outstanding capital stock of NaviSite. If ClearBlue were to convert the Convertible Notes it acquired from CMGI and HPFS as described in note 16 of the financial statements, ClearBlue would own approximately 94% of the outstanding capital stock of NaviSite.

NaviSite and ClearBlue are evaluating the possibility of a business combination involving ClearBlue, its affiliated entities and NaviSite. ClearBlue is our majority stockholder and could unilaterally implement any such combination. The parties expect that such a potential combination could enhance our suite of services, increase revenues, provide significant cost synergies, strengthen the long-term competitive position of the companies and improve operating efficiencies in the two businesses. However, the parties currently have no plan for such a combination and, therefore, the impact of such a combination, if implemented, on our business is undetermined.

Expansion through Acquisitions

With the support of our new majority stockholder, ClearBlue, we are exploring acquisitions in our space as a means to accelerate our business, build scale and solidify our competitive position. Leveraging the high quality of our service delivery function and the operating efficiency of managed services platform, we will seek to structure any acquisitions in this space such that they would be EBITDA accretive soon after integration.

Industry Background

The Overall Market Driver: Growth of Internet Business Applications. We believe that the dramatic growth in Internet usage combined with enhanced functionality, accessibility and security, has made the Internet increasingly attractive to businesses as a medium for communication and commerce. Initial use of the Internet was, for the most part, focused on consumer applications. Businesses are now deploying Internet applications on a large scale, to enhance their core business operations.

As business use of the Internet grows, we believe that businesses utilizing the Internet are seeking to identify and implement increasingly sophisticated Internet applications. These new applications permit businesses to:

- increase operating efficiencies and reduce sales, general and administrative costs;
- engage in business-to-business and business-to-consumer e-commerce;
- build and enhance customer relationships by providing Internet-based customer service and technical support;
- manage vendor and supplier relationships through Web-based technologies such as online training, e-commerce enablement, and streaming; and
- communicate and conduct business more rapidly and cost-effectively with customers, suppliers and employees worldwide.

As a result, the proliferation of business Web sites and Internet applications has created a strong underlying demand for specialized information technology support and application expertise. Tier 1 Research has estimated that the managed hosting market will rise from \$4.3 billion in 2002 to \$7.5 billion in 2005.

Underlying Demand: Movement Toward Outsourcing. A growing number of businesses using the Internet as part of their business strategy have chosen to outsource Internet application development, implementation and support, particularly the hosting and management of their Web sites and Internet applications.

The outsourced hosting and management of Web sites and Internet applications is driven by a number of factors, including:

- the need to improve the reliability, availability and overall performance of Internet applications and Web sites as those applications increase in importance and complexity;

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requirements for rapid time to market and a reduced time to deploy operationally efficient Internet applications;

challenges faced by businesses in hiring, training and retaining application engineers and information technology employees with the requisite range of IT expertise;

increasing complexity of managing the operations of Web sites; and

deployment risk and the risk of technological obsolescence as businesses attempt to capitalize on leading-edge technologies.

Challenging Market in the Near Term: Service Provider Market Consolidation. As the United States economy slowed down over the past few years, enterprises re-evaluated their existing IT budgets and planned spending. Projects not deemed critical to the bottom line were put on hold while existing projects were required to meet the more rigorous demand of lower costs and increased efficiency.

Concurrent with the dot-com shakeout, this slowdown in corporate IT spending has dramatically compounded the problems of excess capacity within the overall IT industry. As a result, mergers, acquisitions, bankruptcies and liquidations have been the dominant trends in the telecommunications, service providers and professional services segments of the IT services market. Regarding their purchasing decisions, customers have taken a cautious approach towards their service providers and technology partners.

Strategic Considerations: Evolution of Complex Managed Services. The market for managed services has evolved rapidly over the past few years. While co-location providers at the low-end of the hosting market have faced significant pricing pressures, the high-end of the market, particularly complex managed services, continues to grow. Web sites with simple e-commerce functionality two years ago have progressed into more complex transaction processing tools. Back-end connectivity, integration with legacy business systems, an increased focus on business continuance and security are characteristic of this progression.

As ISVs and other companies begin to deploy application or Web services, new application management requirements are emerging. Customer demands for remote management services across geographically dispersed IT topologies further drive the move towards complex managed services.

Strategy

NaviSite's objective is to be the trusted, full service provider of outsourced application services to the mid-sized enterprise spending between \$300,000 to \$1 million per year on its Internet applications. We seek to achieve this goal by continuing to enhance and leverage our expertise, service offerings and infrastructure to provide customers with integrated, reliable and secure Internet-based business solutions. Four key components of our strategy include:

Deliver Industry-Leading Operational Metrics. NaviSite has developed, and delivers to its customers, consistently high levels of operational metrics across the areas that are most critical to businesses, including the performance of customer applications, network elements, and service levels. We believe our operating metrics are among the highest metrics in the managed services industry. Because the quality, service level and efficiency of our managed services are transparent, we believe that our operating metrics are a critical differentiator in the marketplace. NaviSite plans to continue driving improvements in its operating metrics and corresponding improvements in the quality of its customer service.

Focus on High Value-Added Managed Services. NaviSite currently provides horizontal application and infrastructure services that have broad appeal across most market segments, including a wide range of industry

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segments, including enterprises, ISVs and e-commerce companies. To meet the changing needs of our current and prospective customer base, we intend to augment our current service offerings by focusing on a sub-set of complex, scale and expertise driven services that build on our value proposition of outsourced IT operations. As a practice, we focus on network and application services that are repeatable, meaning that they require minimal additional customization and integration. We believe that this repeatability decreases our time to market, reduces our operating risks and produces a higher return on our investment and provides higher levels of consistency to our customers.

Partner to Deliver Integrated Application Solutions. We believe that companies will require an increasingly diverse range of capabilities and point technologies as their applications and application ecosystems increase in complexity. While NaviSite specializes in delivering highly scalable management services for the infrastructure, network and foundation application layers of the application stack, we intend to leverage relationships with key system integration and technology partners for services that extend beyond our product range. Driven by differences in economic models, these are services that we will not perform ourselves, but rather, will leverage partners in order to deliver integrated, customized and complete solutions to our end-user customers.

Build Leveraged Distribution Channels with Strategic Partners. Historically, NaviSite has built strong industry relationships with leading technology companies. We work closely with a small and select group of partners to jointly develop higher value proposition offerings and distribute them through joint marketing and sales efforts. We believe that by leveraging our industry relationships, and our partners' distribution capabilities, we are able to increase visibility and sales productivity.

The NaviSite Solution

NaviSite provides a range of integrated, scalable Web hosting and remote business application management services that can be deployed in a cost-effective and rapid manner. We specialize in developing, deploying and managing dedicated mission critical Web-based solutions for our customers. We serve as the single point of management for their Web-based business applications and our focus on management of customer business computing infrastructure allows us to meet an expanding set of customer needs as their applications become more complex. Key advantages of our solution include:

Comprehensive and Integrated Solutions. We provide an integrated suite of products and services that address the full application stack including data center, bandwidth, storage, servers, security, databases, OS, Web and application servers and enterprise resource applications. Further, we provide our services across Unix, Windows, and Linux platforms and in highly secure, highly available and redundant environments.

Cost-Effective Management Services. The combination of our scalable infrastructure, the repeatability of our management processes and our extensive base of expertise allow us to provide our customers with Web-based business application hosting and management services on a cost-effective basis. Because NaviSite has already deployed state-of-the-art infrastructure from the industry's leading providers, our customers can immediately leverage equipment and services that would typically not be cost effective for them to purchase and deploy themselves. Second, we have made significant investments in our operating platform and our automation capabilities. Furthermore, we have refined these processes over time and across a large base of customers. By leveraging this expertise, we can more efficiently configure, deploy and manage complex applications and, thus, save our customers from hiring or developing that same expertise in-house. By off-loading these resources and time-intensive Web site operations, we allow our customers to focus on their core business. We believe that our customers would otherwise be required to make significant expenditures to replicate our performance, reliability and expertise either internally or by using outside vendors.

Location Independent. Our management services can be delivered to customers located at customer and third-party data centers. This capability enables us to capture the full potential of the managed services market where a vast majority of all computing infrastructure are located at the customer's premises. By leveraging the

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experience, tools and processes developed over the last six years, we can drive down incremental management costs and deliver a higher value for our customers.

Rapid Deployment. We offer our customers the ability to rapidly deploy, scale and adapt their Web-based business applications, often in a matter of days or weeks, rather than months. Because NaviSite has already deployed sophisticated infrastructure components and has the experience of deploying similar applications for hundreds of customers, we believe that we can deploy sophisticated Web sites much more rapidly than businesses can in-house. This is especially important to many of our customers who deploy mission critical applications for revenue enhancement or cost improvement objectives.

High-Performance Infrastructure. Our infrastructure has been built by integrating best of breed components and has been designed specifically to meet the more demanding technical requirements of providing managed application hosting, compared to co-location hosting services. Our high-performance infrastructure, together with our trained and experienced staff, enable us to offer levels of service which are backed by high service level guarantees.

Services, Managed Services Platform, Technology and Operations

Management Services. NaviSite provides management services for the lifecycle of Internet and Internet enabled applications. These management services include: (1) architecture, deployment and testing of an application; (2) problem resolution management; (3) application change management; (4) root cause analysis and proactive change; and (5) integration management services. Further, as these applications are increasingly deployed across distributed geographies and topologies and/or distributed points of integration both with legacy systems and other Web services, the ability to perform these management services exponentially increases in complexity.

Managed Internet Applications. We serve our customers as the single point of management for their end-to-end custom e-business applications and their Internet enabled packaged enterprise application suites. Whether NaviSite manages the customer application itself, or partners with application developers who design and build custom applications on top of our managed services platform, NaviSite serves its customers as a full-service provider of outsourcing application management. Additionally, NaviSite also partners with system integration firms in order to deliver outsourced Internet enabled enterprise applications. Through these partnerships, we are able to provide customers with complex enterprise solutions through leveraged distribution channels.

Managed Servers. NaviSite manages physical servers and application servers on the Sun, Windows and Linux platforms. These services are intended for customers who are interested in managing their own custom applications, but want to outsource management of the physical infrastructure and the software infrastructure. NaviSite specializes in the management of the OS, Web servers, database servers, application servers and integration and transaction processing middleware.

Network Security, Storage and Backup. Our network incorporates host-based security with CheckPoint back-end firewalls and Cisco router access control lists, as well as SecureID token-based authentication. In addition to these physical security measures, we have a formal security policy in place, including employee training, that governs all facets of our business and guidelines governing internal and external access to information housed in our network system. We deliver a number of high capacity managed storage services built on EMC, Sun, HP/Compaq and Net Appliance products. We offer incremental, differential and full backup and restore capabilities for all customer applications and data.

Managed Services Platform. In order to service our customers requirements effectively and efficiently, we leverage our managed services platform which consists of an integrated set of proprietary work processes, business support systems, best of breed software and automation platforms. Some of these tools include a knowledge-based problem resolution and trouble-ticketing system, a distributed monitoring and management

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platform, sophisticated data storage system, a corporate intranet with built-in document management and source control system. These tools are unique in their integration with each other and our proprietary workflows, work processes and procedures. We continue to refine and improve these capabilities and we have sought to integrate our platform with those of our system integration partners and customers. We believe our platform and our ability to work with partners is a source of differentiation and competitive advantage.

Network Operations Centers. We monitor the operations of our infrastructure and customer Internet applications from our own network operations centers. Our primary network operations center in Andover is fully staffed 24 hours a day, seven days a week with Network, Security, Windows NT and UNIX personnel. We run a fully operational real-time backup network operations center in San Jose, California. Our network operations centers perform first-level problem identification, validation and resolution. The design of our network operations centers allows network engineers and support personnel to be promptly alerted to problems and we have established procedures for rapidly resolving any technical issues that arise. Network management and monitoring tools continuously monitor the network and server performance.

Data Centers. We currently serve customers from two data centers located in Andover, Massachusetts and in San Jose, California. These state-of-the-art data centers incorporate technically sophisticated components, which are designed to be fault-tolerant. The components used in our data centers include Cisco redundant core routers, Cisco redundant core switching hubs and secure virtual local area networks. We utilize the equipment and tools necessary for our data center operations, including our infrastructure hardware, networking and software products, from industry leaders such as BMC, Cisco, Hewlett Packard, Dell, EMC, Microsoft, Oracle and Sun Microsystems.

Private Transit Internet Connectivity. Our use of direct private transit Internet connections to three major Internet backbone providers differentiates our network infrastructure from those of our competitors. We have redundant high-capacity Internet connections to UUNet, InterNap, and Cable and Wireless on the east coast and UUNet and InterNap on the west coast. We have deployed direct private transit Internet connections specifically to avoid congestion and data loss at public Internet exchange points and the resulting degradation of performance. Our private transit system enables us to provide fast, reliable access for our customers' Web sites and Internet applications.

Service Level Agreements. The combination of our state-of-the-art infrastructure, our customer-focused operations group and our hosting and management expertise enable us to offer our customers guaranteed service levels. For example, one of our offerings is a 99.99% full site high availability service level agreement that covers their entire application.

Sales and Marketing

Our sales and marketing strategy is to cost effectively penetrate the mid-sized enterprise market through a combination of direct sales and channel partnerships.

Direct Sales. Our direct sales professionals are organized into groups located in Andover, Massachusetts, New York, New York, San Francisco, San Jose and Los Angeles, California, and Vienna, Virginia.

Channel Sales. We have developed important industry relationships to enhance our channel sales and marketing capabilities. We have developed a range of partnerships, including relationships with many companies that have formally joined NaviSite's Alliance program, including Web and application developers, system integrators/consultants, ISVs, and technology partners. These partners provide complementary services and, thus, allow NaviSite customers to benefit from more comprehensive solutions and this allows NaviSite to focus on its core value-added services. Many of these partners also provide a significant source of lead referrals to NaviSite and, in some cases are also our customers. As a result, many of our partners' customers have become NaviSite customers.

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Marketing. Our marketing group is responsible for building brand awareness through public relations and marketing communications, identifying key market and customer segments and creating marketing programs to target those segments. The marketing organization focuses on supporting the direct sales as well as developing and enhancing channel partner relationships.

Customers

We were organized in 1996 by CMGI to support the networks and host the Web sites of CMGI companies and a number of CMGI affiliates. In the fall of 1997, we began supplying Web site hosting and management services to companies unaffiliated with CMGI. As of July 31, 2002, we had approximately 145 customers, down from 288 customers as of July 31, 2001.

Competition

We compete in the managed application hosting service market. The overall hosting market is fragmented, evolving rapidly, highly competitive and likely to be characterized by industry consolidation. We believe that NaviSite's focus on higher-level managed application services provides significant differentiation from traditional co-location hosting providers, and provides significantly higher customer value. We believe that participants in this market must grow rapidly and achieve a significant presence to compete effectively. We believe that the primary competitive factors determining success in our market include:

- quality of service delivered;
- ability to consistently measure, track and report on operational metrics;
- Web site and Internet application hosting and management expertise;
- fast, redundant, and reliable Internet connectivity;
- a state-of-the-art infrastructure providing availability, speed, scalability and security;
- comprehensive and diverse service offerings and timely addition of value-added services;
- brand recognition;
- competitive pricing; and
- adequate capital to permit continued investment in infrastructure, customer service and support and sales and marketing.

Our current and prospective competitors include:

- other providers of complex Web site hosting and related services, including Digex Corporation, Globix Corporation, Genuity, Inc., divine Managed Services, and a large number of local and regional hosting providers;
- large system integrators and information technology outsourcing firms, including Electronic Data Systems Corporation, International Business Machines Corporation, Accenture; and
- global telecommunications companies, including AT&T and Sprint.

Many of our competitors may be able to develop and expand their network infrastructures and service offerings more rapidly, adapt to new or emerging technologies and changes in customer requirements more quickly, take advantage of acquisitions and other opportunities more readily, devote greater resources to the

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marketing and sale of their services and adopt more aggressive pricing policies than we can. Because of these competitive factors and due to our comparatively small size and our lack of financial resources, we may be unable to successfully compete in the Internet application service market.

In addition, we believe that there will be continued consolidation within the Internet hosting market in which we compete. Our competitors may consolidate with one another or acquire software application vendors or technology providers, enabling them to more effectively compete with us. This consolidation could affect prices and other competitive factors in ways which would impede our ability to compete successfully in the Internet application service market.

Proprietary Rights

We rely on a combination of trademark, service mark, copyright and trade secret laws and contractual restrictions to establish and protect our proprietary rights and promote our reputation and the growth of our business. We do not own any patents that would prevent or inhibit competitors from using our technology or entering our market. While it is our practice to require our employees, consultants and independent contractors to enter into agreements containing non-disclosure, non-competition (for employees only) and non-solicitation restrictions and covenants, and while our agreements with some of our customers and suppliers include provisions prohibiting or restricting the disclosure of proprietary information, we can not assure you that these contractual arrangements or the other steps taken by us to protect our proprietary rights will prove sufficient to prevent misappropriation of our proprietary rights or to deter independent, third-party development of similar proprietary assets. In addition, we offer our services in other countries where the laws may not afford adequate protection for our proprietary rights.

We license or lease most technologies used in our Internet application services. Our technology suppliers may become subject to third-party infringement claims, or other claims or assertions, which could result in their inability or unwillingness to continue to license their technology to us. The loss of certain of our technologies could impair our ability to provide services to our customers or require us to obtain substitute technologies of lower quality or performance standards or at greater cost. We expect that we and our customers increasingly will be subject to third-party infringement claims as the number of Web sites and third-party service providers for Web-based businesses grows. We cannot assure you that third parties will not assert claims alleging the infringement of service marks and trademarks against us in the future or that these claims will not be successful. Any infringement claim as to our technologies or services, regardless of its merit, could be time-consuming, result in costly litigation, cause delays in service, installation or upgrades, adversely impact our relationships with suppliers or customers or require us to enter into costly royalty or licensing agreements.

Government Regulation

While there currently are few laws or regulations directly applicable to the Internet or to managed application hosting service providers, due to the increasing popularity of the Internet and Web-based applications, such laws and regulations are being considered and may be adopted. These laws may cover a variety of issues including, for example, user privacy and the pricing, characteristics and quality of products and services. The adoption or modification of laws or regulations relating to commerce over the Internet could substantially impair the future growth of our business or expose us to unanticipated liabilities. Moreover, the applicability of existing laws to the Internet and managed application hosting service providers is uncertain. These existing laws could expose us to substantial liability if they are found to be applicable to our business. For example, we offer services over the Internet in many states in the United States and internationally and we facilitate the activities of our customers in those jurisdictions. As a result, we may be required to qualify to do business, be subject to taxation or be subject to other laws and regulations in these jurisdictions, even if we do not have a physical presence or employees or property there. The application of existing laws and regulations to the Internet or our business, or the adoption of any new legislation or regulations applicable to the Internet or our business, could materially adversely affect our financial condition and operating results.

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Employees

As of July 31, 2002, we had 198 employees. Of these employees, 144 were principally engaged in operations, 18 were principally engaged in sales and marketing, 10 were principally engaged in product development and 26 were principally engaged in finance and administration. None of our employees is party to a collective bargaining agreement and we believe our relationship with our employees is good. We also employ consultants and independent contractors on a regular basis to assist in the completion of projects. Since July 31, 2002, we have implemented additional reductions in force affecting approximately 65 employees.

Certain Risk Factors That May Affect Future Results

The risks and uncertainties described below are not the only risks we face. Additional risks and uncertainties not presently known to us or that are currently deemed immaterial may also impair our business operations. If any of the following risks actually occurs, our financial condition and operating results could be materially adversely affected.

We have a history of losses and may never achieve profitability and may not continue as a going concern. Since our inception in 1996, we have experienced operating losses and negative cash flows for each quarterly and annual period. As of July 31, 2002, we had approximately \$21.8 million of cash and cash equivalents, working capital of \$16.5 million and had incurred losses since inception resulting in an accumulated deficit of \$337.3 million. We believe that, on a standalone basis, we will have sufficient cash resources as of July 31, 2002 to meet the projected needs for working capital and capital expenditures through the end of fiscal year 2003. These projections are based on assumptions that include the maintenance of a certain level of revenue, the improvement in collections of accounts receivable, the ability to achieve projected cash expense reductions and the ability to obtain a waiver for the cash payments for all or a portion of fiscal year 2003 quarterly interest due on the \$65 million Convertible Notes. In addition, we are considering the possibility of business combinations involving our majority stockholder, ClearBlue, and its affiliates, which could also affect our future estimated cash flows. Management is working to address these uncertainties, although we cannot assure you that these efforts will be successful and that we will ever achieve profitability or, if we achieve profitability, that it will be sustainable, or that we will continue as a going concern. See Management's Discussion and Analysis of Financial Condition and Results of Operations and the Company's Consolidated Financial Statements included elsewhere in this report.

ClearBlue is currently a majority stockholder and may have interests that conflict with the interests of our other stockholders. On September 11, 2002, CMGI and HPFS sold and transferred to ClearBlue the following equity and debt interests in NaviSite:

Pursuant to a note and stock purchase agreement by and between ClearBlue and CMGI, CMGI sold and transferred to ClearBlue 71,029,391 shares of NaviSite's common stock representing approximately 76% of the outstanding capital stock of NaviSite, warrants to purchase 5,203,252 shares of NaviSite common stock and a Convertible Note with an aggregate principal amount outstanding of \$10 million.

Pursuant to a note and stock purchase agreement by and between ClearBlue and HPFS, HPFS sold and transferred to ClearBlue 3,207,053 shares of NaviSite common stock, representing approximately 3.4% of the outstanding capital stock of NaviSite and a Convertible Note with an aggregate principal amount outstanding of approximately \$55 million.

As a result of these transactions, ClearBlue owns, directly or indirectly through its wholly owned subsidiaries, approximately 79% of the outstanding capital stock of NaviSite. If ClearBlue were to convert the Convertible Notes it acquired from CMGI and HPFS, ClearBlue would own approximately 94% of the outstanding capital stock of NaviSite. Accordingly, ClearBlue has the power, acting alone, to elect a majority of our board of directors and has the ability to determine the outcome of any corporate action requiring stockholder approval, regardless of how our other stockholders may vote. Under Delaware law, ClearBlue may exercise its

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voting power by written consent, without convening a meeting of the stockholders, which means that ClearBlue could effect a sale or merger of our company without prior notice to, or the consent of, our other stockholders. ClearBlue's ownership may have the effect of delaying, deterring or preventing a change in control of our company or discouraging a potential acquirer from attempting to obtain control of us, which in turn could adversely affect the market price of our common stock.

After the consummation of the above transactions on September 11, 2002, the board of directors of NaviSite, which had consisted of David S. Wetherell and George A. McMillan, elected Andrew Ruhan, Chairman of ClearBlue, and Arthur Becker, director of ClearBlue, to the board. As a result of CMGI's reduction in ownership of NaviSite, Messrs. Wetherell and McMillan resigned from the board effective October 2, 2002. Also, Gabriel Ruhan, the Chief Operating Officer and a director of ClearBlue and the brother of Andrew Ruhan, was subsequently elected to the board. Thus, NaviSite's current board of directors is composed solely of executives of ClearBlue. ClearBlue has the power, acting alone, to maintain a majority of the board of directors and would have the ability to determine the outcome of any corporate actions requiring stockholder approval regardless of how our other stockholders may vote. ClearBlue may have interests that conflict with the interests of our other stockholders.

ClearBlue, as a majority stockholder, may combine NaviSite with ClearBlue or a ClearBlue affiliate, which may result in disruptions to our business or distractions of our management due to difficulties in assimilating acquired personnel and operations. ClearBlue, as the majority stockholder of NaviSite, may combine NaviSite with ClearBlue or a ClearBlue affiliate. If such a business combination occurs, our ongoing business may be disrupted and management's attention and resources may be diverted from other business concerns. Additional risks include the difficulty in assimilating acquired operations, technologies and personnel and changes in management or other key personnel that may harm relationships with our customers and employees. We cannot assure you that, in the event of such a combination with ClearBlue or its affiliates, the combined business, assets or technologies will generate sufficient revenue to offset the associated costs or other adverse effects.

A significant portion of our revenue is currently generated by services provided to CMGI and companies affiliated with CMGI, and the loss of this revenue would substantially impair our operating results and the growth of our business. We anticipate that we will continue to receive a significant portion of our revenue in the future from CMGI and CMGI affiliates. CMGI and CMGI affiliates accounted for approximately 31% of our revenue in fiscal year 2002 and approximately 35% of our revenue for fiscal year 2001. We cannot assure you that revenues generated by CMGI and CMGI affiliates will continue or that we will be able to secure business from other customers to replace this revenue in the future. The loss of revenue from CMGI and CMGI affiliates, or our inability to replace this operating revenue, would substantially impair our operating results and the growth of our business. The number of CMGI and CMGI affiliated customers decreased 66% to 5 at July 31, 2002 from 15 at July 31, 2001, although the revenues from such customers continued to be significant.

We may need to raise additional funds, and such funding may not be available to us on favorable terms, if at all. We currently anticipate that our available cash resources at July 31, 2002 will be sufficient to meet our anticipated needs, barring unforeseen circumstances and subject to the impact of the factors discussed herein, for working capital and capital expenditures through the end of fiscal year 2003. In the event NaviSite's revenues are less than as currently projected by NaviSite, ClearBlue has stated that it will waive or defer the interest payments on the Convertible Notes. Our projected cash usage could be significantly impacted by: (1) our ability to maintain our current revenue levels by retaining existing customer accounts and acquiring revenue growth at levels greater than customer revenue churn; (2) our ability to achieve our projected operating results; (3) our ability to collect accounts receivables in a timely manner; and (4) our ability to achieve expected cash expense reductions. However, we may need to raise additional funds in order to develop new, or enhance existing, services or products, to respond to competitive pressures, to acquire complementary businesses, products or technologies and we cannot assure you that the additional financing will be available on terms favorable to us, if at all. In addition, pursuant to our financing arrangements with HPFS as of October 29, 2001 (which Convertible Notes were subsequently transferred to ClearBlue on September 11, 2002), we may need to obtain approval from ClearBlue for incremental funding, and we may not obtain this approval from ClearBlue.

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The loss of key officers, key management and other personnel could adversely affect our ability to successfully execute our business strategy or to continue to provide services to our customers. We believe that the continued service of key personnel, including Tricia Gilligan, our President and Chief Executive Officer, is a key component of the future success of our business. None of our key officers or personnel is currently a party to an employment agreement with us. This means that any officer or employee can terminate his or her relationship with us at any time. In addition, we do not carry life insurance on any of our key personnel. Furthermore, the loss of key members of our sales and marketing teams or key technical service personnel could jeopardize relations with our customers. Any loss of key technical personnel would jeopardize the stability of our infrastructure and our ability to provide the guaranteed service levels our customers expect. Over the past year, we have had significant reductions in force and a number of departures of key management. In addition, with ClearBlue having recently become our majority stockholder and taken seats on our board of directors, there could be additional changes in management. In the event that future reductions or departures of employees occur, our ability to successfully execute our business strategy or to continue to provide services to our customers, could be adversely affected.

The unpredictability of our quarterly results may adversely affect the trading price of our common stock. Our quarterly operating results may vary significantly from quarter to quarter as a result of a number of factors, many of which are outside of our control and any one of which may cause our stock price to fluctuate. The primary factors that may affect us include the following: reduction of market demand and/or acceptance from our Web site and Internet application hosting and management services; oversupply of data center space in the industry; our ability to develop, market and introduce new services on a timely basis; the length of the sales cycle for our services; the timing and size of sales of our services; the budgeting cycles of our customers and potential customers; downward price adjustments by our competitors; changes in the mix of services provided by our competitors; technical difficulties or system downtime affecting the Internet generally or our hosting operations specifically; our ability to meet any increased technological demands of our customers; the amount and timing of costs related to our marketing efforts and service introductions; and economic conditions specific to the Internet application service provider industry. Due to the above factors, we believe that quarter-to-quarter comparisons of our operating results are not a good indication of our future performance. Our operating results for any particular quarter may fall short of our expectations or those of investors or securities analysts. In this event, the market price of our common stock would be likely to fall.

Our common stock may not be transferred back to the Nasdaq National Market or could be delisted from the Nasdaq SmallCap Market. On February 14, 2002, we received a deficiency notice from Nasdaq indicating that our common stock had not maintained a minimum market value of publicly held shares of \$15,000,000 and had failed to maintain a minimum bid price per share of \$3.00 over the previous 30 consecutive trading days, and that we had until May 15, 2002 to regain compliance with the Nasdaq National Market's listing requirements. Nasdaq informed us that if we failed to demonstrate compliance with Nasdaq's listing requirements on or before May 15, 2002, Nasdaq would provide us with written notification that it had determined that we did not meet the standards for continued listing, and our securities would be delisted from the Nasdaq National Market. On May 10, 2002, we applied to transfer voluntarily to the Nasdaq SmallCap Market. On June 4, 2002, Nasdaq approved our transfer application and our common stock was transferred to the Nasdaq SmallCap Market at the opening of business on June 10, 2002. Although we are eligible to transfer back to the Nasdaq National Market if, among other things, the bid price of our common stock is at least \$1.00 for 30 consecutive trading days by February 10, 2003 and we have maintained compliance with the Nasdaq National Market's continued listing requirements while listed on the Nasdaq SmallCap Market, excluding bid price, we may not meet these requirements. If we are unable to regain compliance with the Nasdaq National Market's listing requirements, our common stock will remain on the Nasdaq SmallCap Market. Moreover, if we fail to meet the Nasdaq SmallCap Market maintenance standards, we could be delisted from the Nasdaq SmallCap Market and may be traded on the over-the-counter electronic bulletin board (OTCBB), which is operated by the National Association of Securities Dealers, Inc. If our common stock is not eligible to transfer back to the Nasdaq National Market in the future or is delisted from the Nasdaq SmallCap Market, this could result in a number of negative implications, including continued reduced liquidity in our common stock as a result of the loss of market efficiencies associated with the Nasdaq National Market and the loss of federal preemption of state securities

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laws as well as the potential loss of confidence by suppliers, customers and employees, the loss of analyst coverage and institutional investor interest, fewer business development opportunities and greater difficulty in obtaining financing.

NaviSite's current board of director composition does not include any independent directors. NaviSite's current board of directors is composed of individuals who are not independent of NaviSite and may have interests that conflict with the interests of our stockholders. In addition, NaviSite's status as a Nasdaq SmallCap listed company requires us to be compliant with Nasdaq regulations, including audit committee composition of three independent directors. NaviSite's audit committee currently does not comply with the audit committee requirements and our continued noncompliance may result in a delisting from the Nasdaq SmallCap Market. Further, the loss of current directors, or NaviSite's inability to attract additional directors, particularly independent directors, could impair our ability to successfully create and execute business strategy, because we substantially rely on their experience and management skills.

You may experience dilution because of recent transactions between ClearBlue, HPFS and CMGI. The Convertible Notes obtained by ClearBlue from HPFS and CMGI includes terms that allow ClearBlue, in its discretion, to convert \$65 million principal amount of Convertible Notes into common stock at a conversion price of \$0.26 per share. This conversion would increase the number of issued and outstanding shares of our common stock by approximately 250 million shares. In addition, upon the prior written consent of ClearBlue, we may pay all or a portion of the interest due to ClearBlue with our common shares. Moreover, if additional funds are raised through the issuance of additional equity or convertible debt securities, your percentage of ownership in us will be reduced and you may experience additional dilution. In certain circumstances, if we issue equity or convertible debt securities at values below those currently held by ClearBlue, we must issue ClearBlue additional shares of our common stock which will further dilute existing stockholders.

If the market for Internet commerce and communication does not continue, or it continues to decrease, there may be insufficient demand for our services and, as a result, our business strategy may not be successful. The increased use of the Internet for retrieving, sharing and transferring information among businesses and consumers has developed only recently, and the market for the purchase of products and services over the Internet is new and emerging. If acceptance and growth of the Internet as a medium for commerce and communication does not continue, our business strategy may not be successful because there may not be a continuing market demand for our Web site and Internet application hosting and management services. Our growth could be substantially impaired if the market for Internet application services fails to continue to develop or if we cannot continue to achieve broad market acceptance.

Our decision to discontinue our practice, on a prospective basis, of obtaining equipment under leases and subsequently renting the equipment to our customers may have a material adverse effect on our future results and business operations. New customers and current customers seeking to renew their agreements will have to obtain equipment directly from equipment vendors. We may not be successful in attracting new customers who would prefer to obtain equipment from us. Current customers may not renew their agreements, but rather, may seek a hosting provider who would also rent equipment directly to them to satisfy their equipment needs. If we are unable to keep our current customers and attract new customers, our future results and business operations could be materially harmed.

Our ability to grow our business would be substantially impaired if we were unable to obtain, on commercially reasonable terms, certain equipment that is currently provided under leases. Certain of the equipment that we use or provide to our customers for their use in connection with our services is provided under lease. We or our customers will have to obtain this equipment for new leases and renewal of existing leases directly, on a stand alone basis. Our business would be substantially impaired if we were unable to obtain or continue these leases on commercially reasonable terms.

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Our ability to successfully market our services could be substantially impaired if we are unable to deploy new Internet applications or if new Internet applications deployed by us prove to be unreliable, defective or incompatible. We cannot assure you that we will not experience difficulties that could delay or prevent the successful development, introduction or marketing of Internet application services in the future. If any newly introduced Internet applications suffer from reliability, quality or compatibility problems, market acceptance of our services could be greatly hindered and our ability to attract new customers could be adversely affected. We cannot assure you that new applications deployed by us will be free from any reliability, quality or compatibility problems. If we incur increased costs or are unable, for technical or other reasons, to host and manage new Internet applications or enhancements of existing applications, our ability to successfully market our services could be substantially impaired.

The market we serve is highly competitive, and we may lack the financial and other resources, expertise or capability needed to capture increased market share or maintain market share. We compete in the Internet application service market. This market is rapidly evolving, highly competitive and likely to be characterized by over capacity and industry consolidation. We believe that participants in this market must grow rapidly and achieve a significant presence to compete effectively. Our business is not as developed as that of many of our competitors. Many of our competitors have substantially greater financial, technical and market resources, greater name recognition and more established relationships in the industry. We may lack the financial and other resources, expertise or capability needed to capture increased market share in this environment in the future.

Any interruptions in, or degradation of, our private transit Internet connections could result in the loss of customers or hinder our ability to attract new customers. Our customers rely on our ability to move their digital content as efficiently as possible to the people accessing their Web sites and Internet applications. We utilize our direct private transit Internet connections to major backbone providers as a means of avoiding congestion and resulting performance degradation at public Internet exchange points. We rely on these telecommunications network suppliers to maintain the operational integrity of their backbones so that our private transit Internet connections operate effectively.

Increased costs associated with our private transit Internet connections could result in the loss of customers or significant increases in operating costs. Our private transit Internet connections are already more costly than alternative arrangements commonly utilized to move Internet traffic. If providers increase the pricing associated with utilizing their bandwidth, we may be required to identify alternative methods to distribute our customers' digital content. We cannot assure you that our customers will continue to be willing to pay the higher costs associated with direct private transit or that we could effectively move to another network approach. If we were unable to access alternative networks to distribute our customers' digital content on a cost-effective basis or to pass any additional costs on to our customers, our operating costs would increase significantly.

If we are unable to maintain existing and develop additional relationships with Internet application software vendors, the sales marketing and provision of our Internet application services may be unsuccessful. We believe that to penetrate the market for Web site and Internet application hosting and management services we must maintain existing and develop additional relationships with industry-leading Internet application software vendors and other third parties. We license or lease select software applications from Internet application software vendors. The loss of our ability to continually obtain and utilize any of these applications could materially impair our ability to provide services to our customers or require us to obtain substitute software applications of lower quality or performance standards or at greater cost. In addition, because we generally license