NAVISITE INC
Form 10-Q
March 15, 2006

Table of Contents

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

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

For the quarterly period ended January 31, 2006

OR

o **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	**52-2137343**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
400 Minuteman Road Andover, Massachusetts	**01810**
(Address of principal executive offices)	(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 þ No o

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 o Accelerated filer o Non-accelerated filer þ

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

Yes o No þ

As of March 9, 2006, there were 28,489,482 shares outstanding of the registrant s common stock, par value $.01 per share.

NAVISITE, INC.
TABLE OF CONTENTS
REPORT ON FORM 10-Q
FOR THE QUARTER ENDED JANUARY 31, 2006

		PAGE
PART I.	**FINANCIAL INFORMATION**	3
Item 1.	Financial Statements	3
	Condensed Consolidated Balance Sheets as of January 31, 2006 and July 31, 2005 (unaudited)	3
	Condensed Consolidated Statements of Operations for the three and six months ended January 31, 2006 and 2005 (unaudited)	4
	Condensed Consolidated Statements of Cash Flows for the six months ended January 31, 2006 and 2005 (unaudited)	5
	Notes to Condensed Consolidated Financial Statements (unaudited)	6
Item 2.	Management s Discussion and Analysis of Financial Condition and Results of Operations	20
Item 3.	Quantitative and Qualitative Disclosures About Market Risk	38
Item 4.	Controls and Procedures	38
PART II.	**OTHER INFORMATION**	38
Item 1.	Legal Proceedings	38
Item 4.	Submission of Matters to a Vote of Security Holders	40
Item 6.	Exhibits	41
Signature		42
Exhibit Index		43

EX-31.1 Section 302 Certification of CEO
EX-31.2 Section 302 Certification of CFO
EX-32.1 Section 906 Certification of CEO and President
EX-32.2 Section 906 Certification of CFO

Table of Contents

PART I: FINANCIAL INFORMATION

Item 1. Financial Statements

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

	January 31, 2006	July 31, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	$ 1,900	$ 6,816
Accounts receivable, less allowance for doubtful accounts of $2,744 and $2,887 at January 31, 2006 and July 31, 2005, respectively	12,083	10,688
Unbilled accounts receivable	432	363
Due from related party	74	101
Prepaid expenses and other current assets	2,629	2,806
Total current assets	17,118	20,774
Property and equipment, net	14,899	15,199
Customer lists, less accumulated amortization of $15,702 and $13,228 at January 31, 2006 and July 31, 2005, respectively	14,089	16,563
Goodwill	43,159	43,159
Other assets	4,384	4,383
Restricted cash	1,004	1,099
Total assets	$ 94,653	$ 101,177
LIABILITIES AND STOCKHOLDERS EQUITY (DEFICIT)		
Current liabilities:		
Accounts receivable financing line, net	$ 20,400	$ 20,347
Notes payable, current portion	1,084	1,145
Notes payable to the AppliedTheory Estate	6,000	6,000
Note payable to related party	3,000	3,000
Convertible notes payable to Waythere (formerly Surebridge)	34,611	35,361
Capital lease obligations, current portion	1,880	1,259
Accounts payable	7,660	8,122
Accrued expenses and other current liabilities	20,181	20,794
Deferred revenue and customer deposits	2,924	2,306
Total current liabilities	97,740	98,334
Capital lease obligations, less current portion	718	1,105
Accrued lease abandonment costs, less current portion	939	1,359
Deferred tax liability	1,925	1,338
Other long-term liabilities	1,272	1,304
Note payable, less current portion	46	409
Total liabilities	102,640	103,849

Commitments and contingencies (Note 12)		
Stockholders equity (deficit):		
Preferred stock, $0.01 par value; Authorized 5,000 shares; Issued and outstanding: no shares at January 31, 2006 and July 31, 2005		
Common stock, $0.01 par value; Authorized 395,000 shares; Issued and outstanding: 28,487 at January 31, 2006 and 28,487 at July 31, 2005	285	285
Deferred compensation		(633)
Accumulated other comprehensive income	159	156
Additional paid-in capital	454,945	453,458
Accumulated deficit	(463,376)	(455,938)
Total stockholders equity (deficit)	(7,987)	(2,672)
Total liabilities and stockholders equity (deficit)	$ 94,653	$ 101,177

See accompanying notes to condensed consolidated financial statements.

Table of Contents

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

	Three Months Ended		Six Months Ended	
	January 31, 2006	January 31, 2005	January 31, 2006	January 31, 2005
Revenue	$ 26,264	$ 28,346	$ 51,674	$ 57,207
Revenue, related parties	41	35	71	68
Total revenue	26,305	28,381	51,745	57,275
Cost of revenue (includes stock-based compensation expense under SFAS 123R of $244 and $494 for three and six months ended January 31, 2006, respectively, $0 for comparable periods of 2005.)	18,693	20,634	36,370	43,454
Impairment, restructuring and other		34		34
Total cost of revenue	18,693	20,668	36,370	43,488
Gross profit	7,612	7,713	15,375	13,787
Operating expenses:				
Selling and marketing (includes stock-based compensation expense under SFAS 123R of $86 and $165 for three and six months ended January 31, 2006, respectively, $0 for comparable periods of 2005.)	3,955	3,234	7,204	6,594
General and administrative (includes stock-based compensation expense under SFAS 123R of $703 and $1,461 for three and six months ended January 31, 2006, respectively, $0 for comparable periods of 2005.)	5,095	5,962	10,980	12,410
Impairment, restructuring and other	377	473	377	1,505
Total operating expenses	9,427	9,669	18,561	20,509
Loss from operations	(1,815)	(1,956)	(3,186)	(6,722)
Other income (expense):				
Interest income	26	15	54	28
Interest expense	(2,015)	(1,927)	(3,992)	(3,825)
Other income (expense), net	130	1	273	76

Loss before income tax expense	(3,674)	(3,867)	(6,851)	(10,443)
Income tax expense	(294)	(765)	(587)	(765)
Net loss	$ (3,968)	$ (4,632)	$ (7,438)	$ (11,208)
Basic and diluted net loss per common share	$ (0.14)	$ (0.17)	$ (0.26)	$ (0.40)
Basic and diluted weighted average number of common shares outstanding	28,481	27,944	28,481	27,936

See accompanying notes to condensed consolidated financial statements.

Table of Contents

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

	Six Months Ended January 31, 2006	Six Months Ended January 31, 2005
Cash flows from operating activities:		
Net loss	$ (7,438)	$ (11,208)
Adjustments to reconcile net loss to net cash provided by (used for) operating activities:		
Depreciation and amortization	6,251	7,354
Impairment of long-lived assets related to abandoned leases		330
Gain on disposal of assets		(13)
Costs associated with abandoned leases	377	1,209
Amortization of warrants	53	53
Non-cash stock compensation	2,120	380
Provision for bad debts	365	1,316
Avasta settlement in common stock		490
Deferred income tax expense	587	765
Changes in operating assets and liabilities, net of impact of acquisitions:		
Accounts receivable	(1,760)	(309)
Unbilled accounts receivable	(69)	536
Due from related party	27	(7)
Prepaid expenses and other current assets, net	(300)	755
Long term assets	(1)	416
Accounts payable	(462)	3,281
Long-term liabilities	(32)	2,565
Accrued expenses, deferred revenue and customer deposits	(222)	(6,395)
Net cash provided by (used for) operating activities	(504)	1,518
Cash flows from investing activities:		
Purchase of property and equipment	(2,298)	(2,141)
Proceeds from the sale of equipment		20
Net cash used for investing activities	(2,298)	(2,121)
Cash flows from financing activities:		
Restricted cash		183
Proceeds from exercise of stock options		89
Proceeds from notes payable	436	703
Repayment of notes payable	(1,610)	(645)
Payments on note payable to Waythere, Inc. (formerly Surebridge)		(800)
Payments on capital lease obligations	(940)	(605)

Net cash used for financing activities	(2,114)	(1,075)
Net decrease in cash	(4,916)	(1,678)
Cash and cash equivalents, beginning of period	6,816	3,195
Cash and cash equivalents, end of period	$ 1,900	$ 1,517
Supplemental disclosure of cash flow information:		
Cash paid for interest	$ 2,248	$ 1,382
Equipment purchased under capital lease agreements	$ 1,179	$ 274

See accompanying notes to condensed consolidated financial statements.

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, outsourc 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 900 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 strategy. 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 31, 2005. 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, 2006 are not necessarily indicative of the results expected for the remainder of the fiscal year ending July 31, 2006.

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 and other assumptions for sublease and lease abandonment reserves.

(b) Revenue Recognition

Revenue consists of monthly fees for Web site and Internet custom and packaged application management, hosting, colocation and professional services. The Company also derives a nonmaterial amount of 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, application management, hosting and colocation revenue 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. In instances where the Company also provides application management

Table of Contents

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

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 $1.2 million, including $0.2 million and $0.1 million which is classified as short-term and is included in Prepaid expenses and other current assets on the Consolidated Balance Sheet as of January 31, 2006 and July 31, 2005, respectively, which primarily represents 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.

(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 on the last day of the fourth 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) Financial Instruments and Concentration of Credit Risk

Our financial instruments include cash, accounts receivable, obligations under capital leases and notes payable. As of January 31, 2006, the carrying cost of these 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 10% and 8% of our total revenue for the six months ended January 31, 2006 and 2005, respectively. Accounts receivable included approximately $2.4 million due from this third-party customer at January 31, 2006.

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

(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 Sheet.

(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. The Company generally grants options under its equity plan that vest as to 25% of the original number of shares on the six month anniversary of the option holder and thereafter in equal monthly amounts over the three year period commencing on the six month anniversary of the option holder.

Prior to the adoption of SFAS 123R, we recognized compensation cost for stock options issued with exercise prices set below market prices on the date of grant. During the three and six months ended January 31, 2005, we recognized compensation expense of approximately $196,000 and $380,000, respectively, for stock options in our Consolidated Statement of Operations. The following table illustrates the effect on net loss and net loss per common share if we had applied the fair value recognition provisions of SFAS 123 to stock based compensation.

	Three Months Ended January 31, 2005 (in thousands, except per share data)	Six Months Ended January 31, 2005 (in thousands, except per share data)
Net Loss, as reported	$ (4,632)	$ (11,208)

Add: Stock based employee compensation expense from the Amended and Restated 2003 Stock Incentive Plan included in reported net loss	$	196	$	380
Deduct: Total stock based employee compensation expense determined under fair value based method for all awards	$	(1,123)	$	(2,359)

Table of Contents

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

	Three Months Ended January 31, 2005 (in thousands, except per share data)	Six Months Ended January 31, 2005 (in thousands, except per share data)
Net Loss, as adjusted	$ (5,559)	$ (13,187)
Net Loss per common share:		
Basic and diluted as reported	$ (0.17)	$ (0.40)
Basic and diluted as adjusted	$ (0.20)	$ (0.47)

Upon adoption of SFAS 123R, we recognized the compensation expense associated with awards granted after August 1, 2005 and the unvested portion of previously granted awards that remain outstanding as of August 1, 2005, in our Consolidated Statement of Operations for the first quarter of fiscal year 2006. During the quarter ended January 31, 2006, we recognized $244,000 in cost of sales compensation expense, $86,000 in sales and marketing compensation expense and $703,000 in general and administrative compensation expense for stock options. For the six months ended January 31, 2006, we recognized $494,000 in cost of sales compensation expense, $165,000 in sales and marketing compensation expense and $1,461,000 in general and administrative compensation expense for stock options.

The total remaining unrecognized compensation cost related to nonvested awards is $5.0 million. The weighted average period over which the cost is expected to be recognized is 1.88 years.

Consistent with our valuation method for the disclosure-only provisions of SFAS 123, we are using the Black-Scholes option pricing model to value the compensation expense associated with our stock-based awards under SFAS 123R. In addition, we estimate forfeitures when recognizing compensation expense, and we will adjust our estimate of forfeitures when they are expected to differ. For the three and six months ended January 31, 2006, we estimated that 15% of options granted will be forfeited before the first vesting tranche. Forfeitures after the first vesting tranche are estimated to not be material.

The fair value of each stock option grant was estimated on the date of grant using the Black-Scholes option pricing model, 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.

	Three Months Ended January 31,		Six Months Ended January 31,	
	2006	2005	2006	2005
Risk-free interest rate	4.44%	3.29%	4.28%	2.91%
Expected volatility	101.21%	120.02%	105.64%	122.85%
Expected life(years)	2.18	2.10	2.18	2.09
Weighted average fair value of options granted	$ 0.73	$ 1.50	$ 0.82	$ 1.60

The following table reflects stock option activity under the Company s equity plans for the six months ending January 31, 2006.

	Weighted	Weighted Average

	Number of Shares	Average Exercise Price	Remaining Contractual Term	Aggregate Intrinsic Value
Options outstanding, beginning of year	6,086,655	$3.26		
Granted	1,080,500	$1.40		
Exercised				
Forfeited or Expired	(680,110)	$4.19		
Options Outstanding, January 31, 2006	6,487,045	$2.86	8.58	$155,030
Options Exercisable, January 31, 2006	3,104,340	$3.53	8.06	$ 8,700

9

Table of Contents

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

(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, 2006 and 2005, 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, 2006, there were 6,250 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. For the three and six months ended January 31, 2005, there were 521,966 and 521,904 dilutive shares, respectively, related to warrants, employee stock options and unissued shares related to the Avasta settlement 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. The Company has determined that reporting revenue at a service offering level is impracticable.

(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 weighted 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 (Accumulated other comprehensive income).

(m) Reclassifications

Certain fiscal quarter 2005 balances have been reclassified to conform to the fiscal quarter 2006 financial statement presentation.

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

(3) Liquidity

As of January 31, 2006, our principal sources of liquidity included cash and cash equivalents and our financing agreement with Silicon Valley Bank (SVB). We had a working capital deficit of $80.6 million, including cash and cash equivalents of $1.9 million at January 31, 2006, as compared to a working capital deficit of $77.6 million, including cash and cash equivalents of $6.8 million, at July 31, 2005.

The total net change in cash and cash equivalents for the six months ended January 31, 2006 was a decrease of $4.9 million. The primary uses of cash during the six months ended January 31, 2006 included $0.5 million of cash used for operating activities, $2.3 million for purchases of property and equipment and approximately $2.5 million in repayments on notes payable and capital lease obligations. Our primary sources of cash during the six months ended January 31, 2006 were $0.4 million in proceeds from notes payable. Net cash used for operating activities of $0.5 million during the six months ended January 31, 2006, resulted primarily from funding our $7.4 million net loss and $2.8 million of net changes in operating assets and liabilities, which was partially offset by non-cash charges of approximately $9.7 million. At January 31, 2006, we had an accumulated deficit of $463.4 million, and have reported losses from operations since incorporation. At July 31, 2005, we had an accumulated deficit of $455.9 million.

Our accounts receivable financing line with SVB allows for maximum borrowing of $20.4 million and expires on April 29, 2006. On January 31, 2006, we had an outstanding balance under the amended agreement of $20.4 million. Borrowings are based on monthly recurring revenue. We are required to prepare and deliver a written request for an advance of up to three times the value of total recurring monthly revenue, calculated to be monthly revenue (including revenue from The New York State Department of Labor) less professional services revenue. SVB may then provide an advance of 85% of such value (or such other percentage as the bank may determine). The interest rate under the amended agreement is variable and is currently calculated at the bank s published prime rate plus 4.0%. The financing agreement also contains certain affirmative and negative covenants and is secured by substantially all of our assets, tangible and intangible. Following the completion of certain equity or debt financings, and provided we continue to meet certain ratios, the interest rate shall be reduced to the bank s prime rate plus 1.0%. In no event, however, will the bank s prime rate be less than 4.25%. The accounts receivable financing line at July 31, 2005 is reported net of the remaining value ascribed to the related warrants of $53,000.

At January 31, 2006, the Company had $1.2 million in outstanding standby letters of credit, issued in connection with facility and equipment lease agreements, which are 100% cash collateralized. Cash subject to collateral requirements has been recorded as restricted cash of which $1.0 million and $1.1 million is classified as non-current on our balance sheet at January 31, 2006 and July 31, 2005, respectively.

We anticipate that we will continue to incur net losses in the future. We have taken several actions we believe will allow us to continue as a going concern, including closing and integrating strategic acquisitions, making changes to our senior management and bringing costs more in line with projected revenue. We will need to find sources of additional financing, or refinance or restructure our existing indebtedness, in order to remain a going concern. In September 2005, we engaged financial advisors to assist us in refinancing our debt and, while there can be no assurances that we will be successful in our refinancing efforts, we believe we will conclude this process prior to our indebtedness coming due. We are obligated to use a significant portion of any proceeds raised in an equity or debt financing or by sales of assets to make payments on the notes payable to Waythere, Inc. (formerly known as Surebridge, Inc.), depending on the total net proceeds received by us in the financing (see Note 10(e)).

Table of Contents

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

Our operating forecast incorporates growth projections from industry analysts for the markets in which we participate. Our forecast also incorporates the future cash flow benefits expected from our continued efforts to increase efficiencies and reduce redundancies. Nonetheless, our forecast includes the need to raise additional funds. Our cash flow estimates are based upon attaining certain levels of sales, maintaining budgeted levels of operating expenses, collections of accounts receivable and maintaining our current borrowing line with SVB among other assumptions, including the improvement in the overall macroeconomic environment. However, there can be no assurance that we will be able to meet such assumptions. Our operating forecast does not depend upon our ability to make additional acquisitions which could be impacted by our current stock price. Our sales estimate includes revenue from new and existing customers, which may not be realized, and we may be required to further reduce expenses if budgeted sales are not attained. We may be unsuccessful in reducing expenses in proportion to any shortfall in projected sales and our estimate of collections of accounts receivable may be hindered by our customers ability to pay. In addition, we are currently involved in various pending and potential legal proceedings. While we believe that the allegations against us in each of these matters are without merit, and/or that we have a meritorious defense in each, we are not able to predict the final outcomes of these matters and the effect, if any, on our business, financial condition, results of operations or cash flows. If we are ultimately unsuccessful in any of these matters, we could be required to pay substantial amounts of cash to the other parties. The amount and timing of any such payments could adversely affect our business, financial condition, results of operations or cash flows.

(4) Impairment of Long-Lived Assets

During the six months ended January 31, 2005, the Company recorded a $0.3 million impairment charge for property and equipment, consisting primarily of unamortized leasehold improvements related to our 10 Maguire Road facility in Lexington, MA. The impairment charge is included in Impairment, restructuring and other in the accompanying Condensed Consolidated Statements of Operations (see Note 11). No impairment charges related to long-lived assets were recorded during the six months ended January 31, 2006.

(5) Property and Equipment

Property and equipment at January 31, 2006 and July 31, 2005 are summarized as follows:

	January 31, 2006	July 31, 2005
	(In thousands)	
Office furniture and equipment	$ 3,264	$ 3,159
Computer equipment	41,637	38,690
Software licenses	10,945	10,658
Leasehold improvements	9,512	9,369
	65,358	61,876
Less: Accumulated depreciation and amortization	(50,459)	(46,677)
Property and equipment, net	$ 14,899	$ 15,199

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, life of the lease.

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

(6) Intangible Assets

The gross carrying amount and accumulated amortization as of January 31, 2006 and July 31, 2005 for customer lists related to prior acquisitions are as follows:

	January 31, 2006	July 31, 2005
	(In thousands)	
Gross carrying amount	$ 29,791	$ 29,791
Less: Accumulated amortization	(15,702)	(13,228)
Customer lists, net	$ 14,089	$ 16,563

Table of Contents

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

Intangible asset amortization expense for the three and six months ended January 31, 2006 and 2005 aggregated $1.2 million and $2.5 million, and $1.4 million and $2.9 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 2006 includes year to date amortization. Amortization expense related to intangible assets for the next five years is as follows:

Year Ending July 31,	(In thousands)
2006	$ 4,876
2007	$ 3,932
2008	$ 3,044
2009	$ 1,868
2010	$ 1,005

(7) Goodwill

We perform our annual impairment analysis of goodwill on the last day of our fiscal fourth quarter.

(8) 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 $624,000 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, in the fourth quarter of fiscal year 2005, reducing the carrying value of the Interliant Notes to approximately $0.2 million. The final amount and timing of any distributions we will receive on our Interliant Notes has not been determined. It may be greater or less than the remaining $0.2 million carrying value which is included in Other assets on our Consolidated Balance Sheets.

(9) Accrued Expenses and Other Current Liabilities

Accrued expenses and other current liabilities consist of the following:

	January 31, 2006	July 31, 2005
	(In thousands)	
Accrued payroll, benefits and commissions	$ 4,591	$ 3,846
Accrued legal	627	1,361
Accrued accounts payable	2,319	2,896
Accrued interest	7,167	5,494
Accrued contract termination fees	590	429
Accrued lease abandonment costs, current portion	2,050	2,435

Accrued taxes	1,083	1,075
Other accrued expenses and current liabilities	1,754	3,258
	$ 20,181	$ 20,794

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

(10) Debt

Debt consists of the following:

	January 31, 2006	July 31, 2005
	(In thousands)	
Accounts receivable financing line, net	$ 20,400	$ 20,347
Note payable to Atlantic Investors	3,000	3,000
Notes payable to the AppliedTheory Estate	6,000	6,000
Notes payable to landlord	749	1,157
Convertible notes payable to Waythere, Inc. (formerly Surebridge)	34,611	35,361
Other notes payable	381	397
Total	65,141	66,262
Less current portion	65,095	65,853
Long-term debt	$ 46	$ 409

(a) Silicon Valley Bank Financing Arrangements

Our accounts receivable financing line with Silicon Valley Bank allows for maximum borrowing of $20.4 million and expires on April 29, 2006. On January 31, 2006, we had an outstanding balance under the amended agreement of $20.4 million. Borrowings are based on monthly recurring revenue. We are required to prepare and deliver a written request for an advance of up to three times the value of total recurring monthly revenue, calculated to be monthly revenue (including revenue from The New York State Department of Labor) less professional services revenue. SVB may then provide an advance of 85% of such value (or such other percentage as the bank may determine). The interest rate under the amended agreement is variable and is currently calculated at the bank s published prime rate plus 4.0%. The financing agreement also contains certain affirmative and negative covenants and is secured by substantially all of our assets, tangible and intangible. Following the completion of certain equity or debt financings, and provided we continue to meet certain ratios, the interest rate shall be reduced to the bank s prime rate plus 1.0%. In no event, however, will the bank s prime rate be less than 4.25%. The accounts receivable financing line at July 31, 2005 is reported net of the remaining value ascribed to the related warrants of $53,000.

(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. Interest is payable upon demand or, at Atlantic s option, interest may be added to the outstanding balance under the Atlantic Loan. Atlantic may make demand for payment of amounts in excess of the minimum Atlantic Loan amount of $2.0 million (Minimum Loan Amount), with 60 days notice. Atlantic can demand payment of the Minimum Loan Amount with 90 days notice. Under the Atlantic Loan agreement, we can require Atlantic to loan us (1) up to $2.0 million to repay an amount due from CBTM to Unicorn, a party related to NaviSite and Atlantic; (2) $1.0 million for costs associated with our acquisition of Avasta; and (3) up to $500,000 for the post-acquisition working capital needs of Avasta. Atlantic, at its sole and absolute discretion, may advance other amounts to us such that the aggregate amount borrowed by us does not exceed the maximum loan amount, defined as the lesser of $10.0 million or 65% of our consolidated accounts receivables. On May 30, 2003, we repaid $2.0 million of the approximate $3.0 million outstanding under the Atlantic Loan and on June 11, 2003, we borrowed $2.0 million under the Atlantic Loan. At January 31, 2006, we had $3.0 million outstanding under the Atlantic Loan. This amount is shown as Current Note

Payable to Related Party on our Consolidated Balance Sheet. The Atlantic Loan is secured by all of our receivables and is subordinated to the borrowings from Silicon Valley Bank. At January 31, 2006, we had approximately $0.7 million in accrued interest related to this note.

On January 16, 2004, the Atlantic Loan was amended to extend any and all Credit Advances under the Atlantic Loan made prior to, or following, January 16, 2004, to be due on or before the earlier of (i) August 1, 2004 or (ii) five (5) business days following the closing of a financing transaction or disposition pursuant to which the Borrower receives gross proceeds of $13.0 million. Since January 16, 2004, the parties have agreed on several occasions to extend the maturity date of the Atlantic Loan, most recently on January 31, 2006, when the Atlantic Loan was amended to extend any and all Credit Advances under the Atlantic Loan made prior to, or following, January 31,

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

2006, to become due on the earlier of (i) April 3, 2006 or (ii) five (5) business days following the closing of a financing transaction or disposition pursuant to which the Borrower receives net proceeds of $13.0 million after first satisfying the mandatory prepayment obligation under those certain Notes due to Waythere, Inc. (formerly known as Surebridge, Inc.).

(c) Notes Payable to the AppliedTheory Estate

As part of CBTM s acquisition of certain AppliedTheory assets, CBTM entered into 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, 2006, we had approximately $0.3 million in accrued interest related to these notes.

(d) 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 were transferred into a note payable (Landlord Note). The 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 on November 1, 2006. 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.

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 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 on March 1, 2007.

(e) Convertible Notes Payable to Waythere, Inc. (formerly Surebridge)

On June 10, 2004, in connection with our acquisition of the Surebridge business, we issued two convertible promissory notes in the aggregate principal amount of approximately $39.3 million. Upon final resolution of the net worth calculation, we entered into an agreement, on October 19, 2005, with Waythere, Inc. reducing the outstanding principal balance on the outstanding notes by approximately $3.1 million. Interest shall accrue on the unpaid balance of the notes at the annual rate of 10%, provided that if an event of default shall occur and be continuing, the interest rate shall be 15%. Notwithstanding the foregoing, no interest shall accrue or be payable on any principal amounts repaid on or prior to the nine-month anniversary of the issuance date of the notes. We must repay the outstanding principal of the notes with all interest accrued thereon, no later than June 10, 2006. Pursuant to the terms of the acquisition agreement, $0.8 million of the primary note was callable at anytime for a period of one year from June 10, 2004, the date of closing. During the first quarter of fiscal year 2005, the noteholder requested payment of $0.8 million and we paid this amount during the second quarter of fiscal year 2005.

In addition, if we realize net proceeds in excess of $1.0 million from certain equity or debt financings or sales of assets, we are obligated to make payments on the notes equal to 75% of the net proceeds.

It shall be deemed an event of default under the notes if, among other things, we fail to pay when due any amounts under the notes, if we fail to pay when due or experience an event of default with respect to any debts having an outstanding principal amount of $500,000 or more, if we are delisted from the Nasdaq Capital Market, or if we are acquired and the acquiring party does not expressly agree to assume the notes. In addition, certain bankruptcy, reorganization, insolvency, dissolution and receivership actions would be deemed an event of default under the notes. If an event of default under the notes occurs, the holder shall be entitled to declare the notes immediately due and payable in full.

The notes provide that we shall not incur any indebtedness in excess of $20.5 million in the aggregate, unless such indebtedness is unsecured and expressly subordinated to the notes, is otherwise permitted under the notes, or the proceeds are used to make payments on the notes.

On July 29, 2005, the Company entered into a Consent and Waiver Agreement with Waythere, Inc., whereby the parties agreed that the Company would pay $750,000 of the proceeds from the MBS transaction to Waythere, Inc., reducing the principal amounts outstanding under the notes. On August 1, 2005, the Company paid $750,000 pursuant to the terms of the Consent and Waiver Agreement in connection with the MBS transaction.

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

Finally, the outstanding principal of, and accrued interest on, the notes are convertible into shares of NaviSite common stock at a conversion price of $4.642 at the election of the holder at any time following:

§ the 18-month anniversary of the closing if the aggregate principal outstanding under the notes at such time is greater than or equal to $10.0 million;

§ the second anniversary of the closing; and

§ an event of default thereunder.

As of January 31, 2006, the balance of interest accrued under the promissory notes we issued to Waythere, Inc. was approximately $5.9 million.

(11) Commitments and Contingencies

(a) Leases

Abandoned Leased Facilities: During the second quarter of fiscal year 2006, we recorded lease impairment charges of approximately $0.4 million due to revisions in sublease assumptions for previously abandoned facilities. During the first half of fiscal year 2005, we recorded $1.2 million of lease impairment charges, resulting from costs associated with the abandonment of administrative space at 10 Maguire Road, in Lexington, MA, an adjustment relating to a lease modification for one of our Syracuse facilities and revisions in assumptions associated with other impaired facilities.

All lease impairment expense amounts recorded are included in the captions 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, 2006 are as follows (in thousands):

Lease Abandonment Costs for:	Balance at July 31, 2005	Expense	Purchase Accounting and Other Adjustments	Payments, less accretion of interest	Balance at January 31, 2006
Andover, MA	$ 796	$	$	$ (104)	$ 692
Chicago, IL	866		7	(62)	811
Houston, TX	699	123		(215)	607
Syracuse, NY	255	151		(171)	235
Syracuse, NY	36	11		(16)	31
San Jose, CA	582	92		(285)	389
Atlanta, GA	124			(48)	76
Atlanta, GA	66			(57)	9
Lexington, MA	370			(231)	139
	$ 3,794	$ 377	$ 7	$ (1,189)	$ 2,989

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 are as follows as of January 31, 2006:

Description	Total	Less than 1 Year	Year 2	Year 3	Year 4	Year 5	After Year 5
				(In thousands)			

Short/Long-term debt	$ 65,142	$ 65,096(a)	$ 46	$	$	$	$
Interest on debt [b]	8,812	8,811	1				
Capital leases	3,183	2,258	881	44			
Operating leases	51	47	4				

16

Table of Contents

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

Description	Total	Less than 1 Year	Year 2	Year 3	Year 4	Year 5	After Year 5
			(In thousands)				
Bandwidth commitments	3,026	2,138	626	262			
Maintenance for hardware/software	324	251	69	4			
Property leases [c, d]	42,753	10,289	8,562	6,984	4,719	1,682	10,517
	$ 123,291	$ 88,890	$ 10,189	$ 7,294	$ 4,719	$ 1,682	$ 10,517

(a) Amount includes the outstanding balance on the accounts receivable financing line as of January 31, 2006.

(b) Amounts do not include future interest accruing on the accounts receivable financing line, as interest rate is variable.

(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 will receive $55,682 per month over two years. 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 is restricted pursuant to terms of lease agreements with landlords. At January 31, 2006, this restricted cash of approximately $1.2 million on the accompanying Condensed Consolidated Balance Sheet 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. The suit 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 alleges specifically that Robertson Stephens, in exchange for the allocation to its customers of shares of our common stock sold in our initial public offering, solicited and received from its customers agreements to purchase additional shares of our common stock in the aftermarket at pre-determined prices. The suit seeks unspecified monetary damages and certification of a plaintiff class consisting of all persons who acquired shares of our common stock between October 22, 1999 and December 6, 2000. Three 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), and Binh Nguyen (filed July 10, 2001). Robert E. Eisenberg, our president at the time of the initial public offering in 1999, also was named as a defendant in the Nguyen lawsuit.

On or about June 21, 2001, David Federico filed in the United States District Court for the Southern District of New York a lawsuit against us, Mr. Rosen, Mr. Hale, Robertson Stephens and other 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. The suit generally alleges that the defendants violated the anti-trust laws and the federal securities laws by conspiring and agreeing to raise and increase the compensation received by the underwriter defendants by requiring those who received allocation of initial public offering stock to agree to purchase shares of manipulated securities in the after-market of the initial public offering at escalating price levels designed to inflate the price of the manipulated stock, thus artificially creating an appearance of demand and high prices for that stock, and initial public offering stock in general, leading to further stock offerings. The suit also alleges that the defendants arranged for the underwriter defendants to receive undisclosed and excessive brokerage commissions and that, as a consequence, the underwriter defendants successfully increased investor interest in the manipulated initial public offering of securities and increased the underwriter defendants individual and collective

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

underwritings, compensation, and revenue. The suit further alleges that the defendants violated the federal securities laws by issuing and selling securities pursuant to the initial public offering without disclosing to investors that the underwriter defendants in the offering, including the lead underwriters, had solicited and received excessive and undisclosed commissions from certain investors. The suit seeks unspecified monetary damages and certification of a plaintiff class consisting of all persons who acquired shares of our common stock between October 22, 1999 and June 12, 2001.

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 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 and against us and Messrs. Rosen, Hale and Eisenberg (collectively, the NaviSite Defendants). 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. 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. In connection with the Preliminary Approval Order, the Court scheduled a Fed. R. Civ. P. 23 fairness hearing for April 24, 2006 in order to consider whether to enter final approval of the settlement. Any requests for exclusion or objections to the settlement are to be filed by March 24, 2006. 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 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 more than 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 finalized, we intend to

Table of Contents

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

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.

Wrongful Termination Claim

This lawsuit for wrongful termination was filed in the Superior Court of the State of California, Santa Clara County (Case No. 104CV031471) against NaviSite, Inc. and one of its former employees. Plaintiffs were two female former employees of NaviSite who were terminated from their employment in 2004 as part of a reduction in force. One plaintiff alleged unlawful discrimination based on age and gender, and the other plaintiff alleged unlawful discrimination based on gender and retaliation for taking maternity leave. NaviSite s management and the co-named former employee denied all claims and vigorously defended the lawsuit. On November 1, 2005, NaviSite entered into a settlement agreement with both of the plaintiffs, pursuant to which NaviSite is required to make an aggregate payment of $500,000, payable over time. As of July 31, 2005, we had accrued $500,000 for this settlement, of which we have paid $300,000 in the second quarter and $100,000 in the third quarter of fiscal year 2006. The balance, as of January 31, 2006, is included in Accrued expenses and other current liabilities on our Consolidated Balance Sheet.

(12) 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, 2006, respectively, as compared to $0.8 million and $0.8 million of deferred income tax expense during the comparable periods of fiscal year 2005. 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 at least annually. Tax amortization of goodwill results in a taxable temporary difference, which will not reverse until the goodwill is impaired or at least 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.

Table of Contents

Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

This 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 the heading Certain Risk Factors that May Affect Future Results 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 provides 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. NaviSite provides services throughout the information technology lifecycle. The Company is dedicated to delivering quality services and meets 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 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, we enable solutions and services to a wider and growing customer base.

Our services include:

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.

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.

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.

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

Outsourcing Services

Planning Services Services include IT assessment, enterprise architecture planning, Web strategy, performance assessment and tuning.

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

Management Services Services include custom application management and remote infrastructure management.

Professional Services

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

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 14 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 930 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 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 recent 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, Inc. (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.

The audit report on our fiscal year 2005 consolidated financial statements from KPMG LLP, our independent registered public accounting firm, contains KPMG s opinion that our recurring losses from operations since inception and accumulated deficit, as well as other factors, raise substantial doubt about our ability to continue as a

Table of Contents

going concern. While we cannot give any assurance that we will continue as a going concern, we believe that we have developed and are implementing an operational plan that aligns our cost structure with our projected revenue growth.

Results of Operations for the Three and Six Months Ended January 31, 2006 and 2005

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

	Three Months Ended January 31,		Six Months Ended January 31,	
	2006	2005	2006	2005
Revenue	99.8%	99.9%	99.9%	99.9%
Revenue, related parties	0.2%	0.1%	0.1%	0.1%
Total revenue	100.0%	100.0%	100.0%	100.0%
Cost of revenue	71.1%	72.7%	70.3%	75.9%
Impairment, restructuring and other	0.0%	0.1%	0.0%	0.0%
Total cost of revenue	71.1%	72.8%	70.3%	75.9%
Gross profit	28.9%	27.2%	29.7%	24.1%
Operating expenses:				
Selling and marketing	15.0%	11.4%	13.9%	11.5%
General and administrative	19.4%	21.0%	21.3%	21.7%
Impairment, restructuring and other	1.4%	1.7%	0.7%	2.6%
Total operating expenses	35.8%	34.1%	35.9%	35.8%
Loss from operations	(6.9)%	(6.9)%	(6.2)%	(11.7)%
Other income (expense):				
Interest income	0.1%	0.1%	0.1%	0.1%
Interest expense	(7.7)%	(6.8)%	(7.7)%	(6.8)%
Other income (expense), net	0.5%	0.0%	0.5%	0.1%
Loss before income tax expense	(14.0)%	(13.6)%	(13.3)%	(18.3)%
Income tax expense	(1.1)%	(2.7)%	(1.1)%	(1.3)%
Net loss	(15.1)%	(16.3)%	(14.4)%	(19.6)%

Comparison of the Three and Six Months Ended January 31, 2006 and 2005

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, 2006 decreased 7.3% to approximately $26.3 million from approximately $28.4 million for the three months ended January 31, 2005. Approximately $1.1 million of the $2.1 million decrease in revenue was attributable to the sale in July 2005 of our Microsoft Business Solutions Software Resell and Professional Services Practice with the remaining decrease the result of net lost customer revenue. Revenue from related parties during the three months ended January 31, 2006 and 2005 totaled $41,000 and

$35,000, respectively.

Total revenue for the six months ended January 31, 2006 decreased 9.7% to approximately $51.7 million from approximately $57.3 million for the six months ended January 31, 2005. The sale of the Microsoft Business Solutions Software Resell and Professional Services Practice accounted for $2.4 million of the overall reduction in revenue of $5.5 million, with the remaining decrease in revenue attributable to net lost customer revenue. Revenue from related parties during the six months ended January 31, 2006 and 2005 totaled $71,000 and $68,000, respectively.

One unrelated customer accounted for 10% and 8% of our total revenue during the first half of fiscal year 2006 and 2005, respectively.

Cost of Revenue

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, 2006, decreased approximately 9.6% to $18.7 million from approximately $20.7 million for the three months ended January 31, 2005. As a percentage of revenue, total cost of revenue decreased from 72.8% of revenue for the three months ended January 31, 2005 to 71.1% of revenue for the three months ended January 31, 2006. The decrease in cost of revenue of $2.0 million resulted primarily from decreased salary expense resulting from a reduction in headcount, a decrease in hardware and software maintenance costs, costs related to the sale of our MBS practice, depreciation and amortization and facilities related charges, partially offset by the effect of implementing SFAS 123R. During the three months ended January 31, 2005, we recorded a $34,000 lease abandonment charge related to our data center space located at Westwood Center, Vienna, VA as a component of total cost of revenue. No such charge was recorded during the same period of fiscal year 2006.

Total cost of revenue for the six months ended January 31, 2006, decreased approximately 16.4% to $36.4 million from approximately $43.5 million for the six months ended January 31, 2005. As a percentage of revenue, total cost of revenue decreased from 75.9% of revenue for the six months ended January 31, 2005 to 70.3% of revenue for the six months ended January 31, 2006. The decrease in cost of revenue of $7.1 million resulted primarily from decreased salary expense resulting from a reduction in headcount, a decrease in hardware and software maintenance costs, costs related to the sale of our MBS practice, depreciation and amortization and facilities related charges, partially offset by the effect of implementing SFAS 123R. During the first half of fiscal year 2005, we recorded a $34,000 lease abandonment charge related to our data center space located at Westwood Center, Vienna, VA as a component of total cost of revenue. No such charge was recorded during the same period of fiscal year 2006.

Gross Profit

Gross profit of $7.6 million for the three months ended January 31, 2006 decreased approximately $0.1 million, or 1.3%, from a gross profit of approximately $7.7 million for the three months ended January 31, 2005. Gross profit for the second fiscal quarter of 2006 represented 28.9% of total revenue, as compared to 27.2% of total revenue for the second fiscal quarter of 2005.

Gross profit of $15.4 million for the six months ended January 31, 2006 increased approximately $1.6 million, or 11.5%, from a gross profit of approximately $13.8 million for the six months ended January 31, 2005. Gross profit for the first half of fiscal year 2006 represented 29.7% of total revenue, as compared to 24.1% of total revenue for the first half of fiscal year 2005. The gross profit increase was due to the decline in cost of revenue.

Operating Expenses

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

Selling and marketing expense increased 22.3% to approximately $4.0 million, or 15.0% of total revenue, during the three months ended January 31, 2006 from approximately $3.2 million, or 11.4% of total revenue, during the three months ended January 31, 2005. The increase of approximately $0.7 million resulted primarily from increased sales commissions, the increase of marketing program spending and the effect of implementing SFAS 123R, partially offset by a decrease in headcount related expenses.

Selling and marketing expense increased 9.3% to approximately $7.2 million, or 13.9% of total revenue, during the six months ended January 31, 2006 from approximately $6.6 million, or 11.5% of total revenue, during the six months ended January 31, 2005. The increase of approximately $0.6 million resulted primarily from increased sales commissions, the increase of marketing program spending and the effect of implementing SFAS 123R, partially offset by a decrease in headcount related expenses.

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

General and administrative expense decreased 14.5% to approximately $5.1 million, or 19.4% of total revenue, during the three months ended January 31, 2006 from approximately $6.0 million, or 21.0% of total revenue, during the three months ended January 31, 2005. The decrease of approximately $0.9 million was primarily the result of decreased salary expense resulting from a decreased headcount and decrease in bad debt expense, partially offset by the effect of implementing SFAS 123R.

General and administrative expense decreased 11.5% to approximately $11.0 million, or 21.2% of total revenue, during the six months ended January 31, 2006 from approximately $12.4 million, or 21.7% of total revenue, during the six months ended January 31, 2005. The decrease of approximately $1.4 million was primarily the result of decreased salary expense resulting from a decreased headcount and decrease in bad debt expense, partially offset by the effect of implementing SFAS 123R.

Operating Expenses   Impairment, Restructuring and Other

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, as compared to approximately $0.5 million during the three months ended January 31, 2005. The $0.4 million and $0.5 million charge during the second fiscal quarter of 2006 and 2005 related to revised assumptions associated with our impaired facilities.

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 six months ended January 31, 2006, as compared to approximately $1.5 million during the six months ended January 31, 2005. The $0.4 million charge recorded during the first half of fiscal year 2006 related to revised assumptions associated with our impaired facilities. The $1.5 million charge recorded during the first half of fiscal year 2005 related to revised assumptions associated with our impaired facilities, the abandonment of an administrative facility and an impairment charge for property and equipment, consisting primarily of leasehold improvements, relating to the same location.

Interest Income

During the three and six months ended January 31, 2006, interest income increased 73.3% and 92.9%, respectively, from the comparable prior periods to approximately $26,000 and $54,000, respectively. The increase of $11,000 and $26,000 for the three and six month periods is mainly due to an increase in the rate of interest on our security deposits.

Interest Expense

During the three and six months ended January 31, 2006, interest expense increased 4.6% and 4.4%, respectively, from the comparable prior year periods to approximately $2.0 million and $4.0 million, respectively. The increase of $0.1 million and $0.2 million for the current three and six month periods is primarily related to the addition of capital leases and an increase in the rate of interest on our financing line with SVB.

Table of Contents

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, 2006, respectively, as compared to $0.8 million and $0.8 million of deferred income tax expense during the comparable periods of fiscal year 2005. 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 at least 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, 2006, our principal sources of liquidity included cash and cash equivalents and our financing agreement with Silicon Valley Bank (SVB). We had a working capital deficit of $80.6 million, including cash and cash equivalents of $1.9 million at January 31, 2006, as compared to a working capital deficit of $77.6 million, including cash and cash equivalents of $6.8 million, at July 31, 2005.

The total net change in cash and cash equivalents for the six months ended January 31, 2006 was a decrease of $4.9 million. The primary uses of cash during the six months ended January 31, 2006 included $0.5 million of cash used for operating activities, $2.3 million for purchases of property and equipment and approximately $2.5 million in repayments on notes payable and capital lease obligations. Our primary sources of cash during the six months ended January 31, 2006 were $0.4 million in proceeds from a note payable. Net cash used for operating activities of $0.5 million during the six months ended January 31, 2006, resulted primarily from funding our $7.4 million net loss and $2.8 million of net changes in operating assets and liabilities, which was partially offset by non-cash charges of approximately $9.7 million. At January 31, 2006, we had an accumulated deficit of $463.4 million, and have reported losses from operations since incorporation. At July 31, 2005, we had an accumulated deficit of $455.9 million.

Our accounts receivable financing line with SVB allows for maximum borrowing of $20.4 million and expires on April 29, 2006. On January 31, 2006, we had an outstanding balance under the amended agreement of $20.4 million. Borrowings are based on monthly recurring revenue. We are required to prepare and deliver a written request for an advance of up to three times the value of total recurring monthly revenue, calculated to be monthly revenue (including revenue from The New York State Department of Labor) less professional services revenue. SVB may then provide an advance of 85% of such value (or such other percentage as the bank may determine). The interest rate under the amended agreement is variable and is currently calculated at the bank s published prime rate plus 4.0%. The financing agreement also contains certain affirmative and negative covenants and is secured by substantially all of our assets, tangible and intangible. Following the completion of certain equity or debt financings, and provided we continue to meet certain ratios, the interest rate shall be reduced to the bank s prime rate plus 1.0%. In no event, however, will the bank s prime rate be less than 4.25%. The accounts receivable financing line at July 31, 2005 is reported net of the remaining value ascribed to the related warrants of $53,000.

At January 31, 2006, the Company had $1.2 million in outstanding standby letters of credit, issued in connection with facility and equipment lease agreements, which are 100% cash collateralized. Cash subject to collateral requirements has been recorded as restricted cash of which $1.0 million and $1.1 million is classified as non-current on our balance sheet at January 31, 2006 and July 31, 2005, respectively.

We anticipate that we will continue to incur net losses in the future. We have taken several actions we believe will allow us to continue as a going concern, including closing and integrating strategic acquisitions, making changes to our senior management and bringing costs more in line with projected revenue. We will need to find sources of additional financing, or refinance or restructure our existing indebtedness, in order to remain a going concern. In September 2005, we engaged financial advisors to assist us in refinancing our debt and, while there can be no assurances that we will be successful in our refinancing efforts, we believe we will conclude this process prior to our indebtedness coming due. We are obligated to use a significant portion of any proceeds raised in an equity or debt financing or by sales of assets to make payments on the notes payable to Waythere, Inc. (formerly known as Surebridge, Inc.), depending on the total net proceeds received by us in the financing (see Note 10(e)).

Our operating forecast incorporates growth projections from industry analysts for the markets in which we participate. Our forecast also incorporates the future cash flow benefits expected from our continued efforts to increase efficiencies and reduce redundancies. Nonetheless, our forecast includes the need to raise additional funds. Our cash flow estimates are based upon attaining certain levels of sales, maintaining budgeted levels of operating expenses, collections of accounts receivable and maintaining our current borrowing line with SVB among other assumptions, including the improvement in the overall macroeconomic environment. However, there can be no assurance that we will be able to meet such assumptions. Our operating forecast does not depend upon our ability to make additional acquisitions which could be impacted by our current stock price. Our sales estimate includes revenue from new and existing customers, which may not be realized, and we may be required to further reduce expenses if budgeted sales are not attained. We may be unsuccessful in reducing expenses in proportion to any shortfall in projected sales and our estimate of collections of accounts receivable may be hindered by our customers ability to pay. In addition, we are currently involved in various pending and potential legal proceedings. While we believe that the allegations against us in each of these matters are without merit, and/or that we have a meritorious defense in each, we are not able to predict the final outcomes of any of these matters and the effect, if any, on our business, financial condition, results of operations or cash flows. If we are ultimately unsuccessful in any of these matters, we could be required to pay substantial amounts of cash to the other parties. The amount and timing of any such payments could adversely affect our business, financial condition, results of operations or cash flows.

Recent Accounting Pronouncements

In May 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections: A Replacement of APB Opinion No. 20 and SFAS No. 3. This statement changes the requirements for the accounting for and reporting of a voluntary change in accounting principle, and also applies to instances when an accounting pronouncement does not include specific transition provisions. The statement replaces the previous requirement that voluntary changes be recognized by including the cumulative effect of the change in net income of the period of the change. The statement requires retrospective application of a new accounting principle to prior periods financial statements, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. The statement is effective for changes and corrections made in fiscal years beginning after December 15, 2005. The Company does not expect the adoption of the statement to have a material effect on its financial condition, results of operations or cash flows.

In March 2005, the FASB issued Interpretation (FIN) No. 47, Accounting for Conditional Asset Retirement Obligations an Interpretation of FASB Statement No. 143. This Interpretation clarifies the timing of liability recognition for legal obligations associated with an asset retirement when the timing and (or) method of settling the obligation are conditional on a future event that may or may not be within the control of the entity. FIN No. 47 is effective no later than the end of fiscal years ending after December 15, 2005. We do not believe the adoption of FIN No. 47 will have a material impact on our consolidated financial statements or results of operations.

In November 2005, the FASB issued FSP FAS123(R)-3, Transition Election to Accounting for the Tax Effects of Share-Based Payment Awards. This FSP requires an entity to follow either the transition guidance for the additional-paid-in-capital pool as prescribed in SFAS No. 123(R), Share-Based Payment, or the alternative transition method as described in the FSP. An entity that adopts SFAS No. 123(R) using the modified prospective application may make a one-time election to adopt the transition method described in this FSP. An entity may take up to one year from the later of its initial adoption of SFAS No. 123(R) or the effective date of this FSP to evaluate its available transition alternatives and make its one-time election. This FSP became effective in November 2005. We continue to evaluate the impact that the adoption of this FSP could have on our financial statements.

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, 2006, are as follows:

Table of Contents

Description	Total	Less than 1 Year	1-3 Years	4-5 Years	More than 5 Years
			(In thousands)		
Short/Long-term debt	$ 65,142	$ 65,096(a)	$ 46	$	$
Interest on debt [b]	8,812	8,811	1		
Capital leases	3,183	2,258	925		
Operating leases	51	47	4		
Bandwidth commitments	3,026	2,138	888		
Maintenance for hardware/software	324	251	73		
Property leases [c, d]	42,753	10,289	15,546	6,401	10,517
	$ 123,291	$ 88,890	$ 17,483	$ 6,401	$ 10,517

(a) Amount includes the outstanding balance on the accounts receivable financing line as of January 31, 2006.

(b) Amounts do not include future interest accruing on the accounts receivable financing line, as interest rate is variable.

(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 will receive $55,682 per month over two years. 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 is restricted pursuant to terms of lease agreements with landlords. At January 31, 2006, this restricted cash of approximately $1.2 million on the accompanying Condensed Consolidated Balance Sheet consisted of certificates of deposit and a treasury note and are recorded at cost, which approximates fair value.

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 generally accepted accounting principles 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 of monthly fees for Web site and Internet custom and packaged application management, hosting, colocation and professional services. The Company also derives a nonmaterial amount of 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, application management, hosting and colocation revenue 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. 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.

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 uncollectability 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

Risk Factors That May Affect Future Results

We operate in a rapidly changing environment that involves a number of risks, some of which are beyond our control. Forward-looking statements in this report and those made from time to time by us through our senior management are made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Forward-looking statements concerning the expected future revenues, earnings or financial results or concerning project plans, performance, or development of products and services, as well as other estimates related to future operations are necessarily only estimates of future results and we cannot assure you that actual results will not materially differ from expectations. Forward-looking statements represent management s current expectations and are inherently uncertain. We do not undertake any obligation to update forward-looking statements. If any of the following risks actually occurs, our business, financial condition and operating results could be materially adversely affected.

We have negative working capital and significant indebtedness that must be repaid in the first half of calendar 2006; therefore, we need to obtain additional financing, which may not be available on favorable terms, or at all. We need to raise additional capital and it may not be available on favorable terms or at all. As of January 31, 2006, we had approximately $1.9 million of cash and cash equivalents and a working capital deficit of approximately $80.6 million. As of January 31, 2006, our outstanding balance under our Silicon Valley Bank amended accounts receivable financing agreement, which matures on April 29, 2006, was $20.4 million. As of January 31, 2006, our outstanding principal and accrued interest under the promissory notes we issued to Waythere, Inc. (in connection with the Surebridge acquisition), which mature on June 10, 2006, was approximately $40.5 million. As of January 31, 2006, our outstanding principal and accrued interest owed to Atlantic Investors, LLC, which matures upon the earlier to occur of April 3, 2006 or five business days after our receipt of net proceeds from a financing or a sale of assets of at least $13.0 million, after our satisfaction of the mandatory prepayment obligations under the promissory notes issued to Waythere, was approximately $3.7 million. As of January 31, 2006, our outstanding principal and accrued interest owed to the AppliedTheory Estate, which is due on June 13, 2006, was approximately $6.3 million. If we do not raise sufficient capital to repay our indebtedness or, if we do not refinance or restructure our indebtedness, a substantial amount of which becomes due and payable during calendar year 2006, our business likely will not continue as a going concern.

We have a history of losses and may never achieve or sustain profitability and may not continue as a going concern. We have never been profitable and may never become profitable. Since our incorporation in 1998, we have experienced operating losses and negative cash flows for each annual period. As of January 31, 2006, we had incurred losses since our incorporation resulting in an accumulated deficit of approximately $463.4 million. During the fiscal quarter ended January 31, 2006, we had a net loss of approximately $4.0 million. The audit report from KPMG LLP, our independent registered public accounting firm, relating to our fiscal year 2005 financial statements contains KPMG s opinion that our recurring losses from operations since inception and accumulated deficit, as well as other factors, raise substantial doubt about our ability to continue as a going concern. We anticipate that we will continue to incur net losses in the future. We also have significant fixed commitments, including with respect to real estate, bandwidth commitments and equipment leases. As a result, we can give no assurance that we will achieve profitability or be capable of sustaining profitable operations. If we are unable to reach and sustain profitability, we risk depleting our working capital balances and our business may not continue as a going concern.

The convertible promissory notes we issued in the Surebridge acquisition may negatively affect our liquidity and our ability to obtain additional financing and operate and manage our business. On June 10, 2004, in connection with our acquisition of the Surebridge business, we issued two convertible promissory notes in the aggregate principal amount of approximately $39.3 million. We must repay the remaining outstanding principal of the notes, with all accrued interest, no later than June 10, 2006. On December 31, 2004, we repaid $800,000, and on August 1, 2005 we repaid $750,000 of the outstanding principal of the notes. The principal amounts under the promissory notes were further reduced by approximately $3.1 million as a result of certain working capital adjustments the parties agreed to in the original asset purchase agreement. Accrued interest related to the notes amounted to approximately $5.9 million as of January 31, 2006. If we realize net proceeds in excess of $1.0 million from equity or debt financings or sales of assets, we are obligated to make a payment on the notes equal to 75% of the net proceeds. The notes, or the prepayment obligation under the notes, may adversely affect our ability to raise or retain additional capital. If we commit an event of default under any of the promissory notes, which may include

Table of Contents

a default of obligations owed to other third parties, prior to the maturity date of the promissory notes, then the holders of the promissory notes may declare the notes immediately due and payable, which would adversely affect our liquidity and our ability to manage our business. Furthermore, the promissory notes contain restrictive covenants, including with respect to our ability to incur additional indebtedness.

Our common stockholders may suffer significant dilution in the future upon the conversion of outstanding securities and the issuance of additional securities in potential future acquisitions or financings. The outstanding principal and accrued interest on the two promissory notes issued to Waythere, Inc. (formerly known as Surebridge, Inc.) are convertible into shares of our common stock at a conversion price of $4.642, at the election of the holder. If the promissory notes are converted into shares of common stock, Waythere may obtain a significant equity interest in NaviSite and other stockholders may experience significant and immediate dilution. Should Waythere elect to convert the entire principal and accrued interest outstanding under of its two convertible promissory notes into shares of our common stock, Waythere would own approximately 11.7 million shares of our common stock. Based on our capitalization as of January 31, 2006, Waythere would own approximately 32% of our outstanding shares of common stock.

In addition, our stockholders will experience further dilution to the extent that additional shares of our common stock are issued in potential future acquisitions or financings.

On January 22, 2004, we filed with the Securities and Exchange Commission a Registration Statement on Form S-2 to register shares of our common stock to issue and sell in a public offering to raise additional funds. In the event we are not successful in raising capital through this public offering, we will be required to expense $0.7 million of associated offering expenses which are presently included in Prepaid expenses and other current assets on our January 31, 2006 Consolidated Balance Sheet. If we do not complete the planned public offering, or if we do complete the planned public offering and then use a significant portion of the net proceeds we receive to repay debt or acquire a company, technology or product, we will need to raise additional capital through various other equity or debt financings, and such capital may not be available on favorable terms or at all.

Our financing agreement with Silicon Valley Bank includes various covenants and restrictions that may negatively affect our liquidity and our ability to operate and manage our business. As of January 31, 2006, we owed Silicon Valley Bank approximately $24.0 million under our amended accounts receivable financing agreement. The accounts receivable financing agreement restricts our ability to:

- create or incur additional indebtedness;
- sell, or permit any lien or security interest in, any of our assets;
- enter into or permit any material transaction with any of our affiliates;
- merge or consolidate with any other party, or acquire all or substantially all of the capital stock or property of another party, unless, among other things, the other party is in the same, or a similar line of business as us;
- relocate our principal executive office or add any new offices or business locations;
- change our state of formation;
- change our legal name;
- make investments;
- pay dividends or make any distribution or payment or redeem, retire or purchase our capital stock; and

make or permit any payment on subordinated debt or amend any provision in any document relating to any subordinated debt.

Further, the accounts receivable financing agreement requires that we maintain EBITDA of at least $1.00 for every fiscal quarter. The agreement defines EBITDA as earnings before interest, taxes, depreciation and amortization in accordance with generally accepted accounting principles and excluding acquisition-related costs and one-time extraordinary charges.

If we breach our accounts receivable financing agreement with Silicon Valley Bank, a default could result. A default under the accounts receivable financing agreement may be deemed to have occurred upon an event of default under the promissory notes issued in the Surebridge transaction. A default, if not waived, could result in, among other things, us not being able to borrow additional amounts from Silicon Valley Bank. In addition, all or a portion of our outstanding amounts may become due and payable on an accelerated basis, which would adversely affect our liquidity and our ability to manage our business. A default under the accounts receivable financing agreement could also result in a cross-default under the promissory notes issued to Waythere in connection with the Surebridge transaction. This would accelerate the repayment obligation on the promissory notes and would allow Waythere to elect to convert the principal and accrued interest into shares of our common stock. All amounts due and outstanding under the accounts receivable financing agreement are due to be repaid in April 2006.

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 10% of our consolidated revenue for the six months ended January 31, 2006. The New York State Department of Labor has been a long-term customer of ours, but we cannot assure you that we will be able to retain this customer. We also cannot assure you that we will be able to maintain the same level of service to this customer or that our revenue from this customer will not significantly decline in future periods. On August 16, 2005, we entered into a new agreement with the New York State Department of Labor with a two year term which is set to expire on June 14, 2007. The New York State Department of Labor is not obligated under our new agreement to buy a minimum amount of services from us or designate us as its sole supplier of any particular service. Further, The New York State Department of Labor has the right to terminate the new agreement at any time by providing us with 60 days notice. If we were to lose this customer or suffer a material reduction in the revenue generated from this customer, it would have a significant adverse impact on our business results and cash flows.

Atlantic Investors may have interests that conflict with the interests of our other stockholders and, as our majority stockholder, can prevent new and existing investors from influencing significant corporate decisions. Atlantic Investors owns approximately 60% of our outstanding capital stock as of January 31, 2006. In addition, Atlantic Investors holds a promissory note in the principal amount of $3.0 million due upon the earlier to occur of April 3, 2006, and five business days after our receipt of net proceeds from a financing or a sale of assets of at least $13.0 million, after our satisfaction of the mandatory prepayment obligations under the promissory notes issued to Waythere. As of January 31, 2006, we had recorded accrued interest on this note in the amount of $0.7 million. Atlantic Investors has the power, acting alone, to elect a majority of our Board of Directors and has 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 has the ability to control the election of directors and 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 is able to exercise its voting power by written consent, without convening a meeting of the stockholders. Atlantic Investors ownership of a majority of our outstanding common stock may have the effect of delaying, deterring or preventing a change in control of us or discouraging a potential acquiror from attempting to obtain control of us, which could adversely affect the market price of our common stock.

Members of our management group also have significant interests in Atlantic Investors, LLC, which may create conflicts of interest. Some of the members of our management group also serve as members of the management group of Atlantic Investors, LLC and its affiliates. Specifically, Andrew Ruhan, our Chairman of the Board, holds a 10% equity interest in Unicorn Worldwide Holdings Limited, a managing member of Atlantic Investors. Arthur Becker, our President and Chief Executive Officer and a member of our Board of Directors, is the managing member of

Madison Technology LLC, a managing member of Atlantic Investors. As a result, these officers and directors may face potential conflicts of interest with each other and with our stockholders. They may be presented with situations in their capacity as our officers or directors that conflict with their fiduciary obligations to Atlantic Investors, which in turn may have interests that conflict with the interests of our other stockholders.

Acquisitions may result in disruptions to our business or distractions of our management due to difficulties in integrating acquired personnel and operations, and these integrations may not proceed as planned. Since December 2002, we have acquired CBTM (accounted for as an as if pooling), Avasta, Conxion, selected assets of Interliant, all of the shares of ten wholly-owned subsidiaries of CBT (accounted for as an as if pooling) and substantially all of the assets and liabilities of Surebridge. We intend to continue to expand our business through the acquisition of companies, technologies, products and services. Acquisitions involve a number of special problems and risks, including:

- difficulty integrating acquired technologies, products, services, operations and personnel with the existing businesses;
- difficulty maintaining relationships with important third parties, including those relating to marketing alliances and providing preferred partner status and favorable pricing;
- diversion of management s attention in connection with both negotiating the acquisitions and integrating the businesses;
- strain on managerial and operational resources as management tries to oversee larger operations;
- inability to retain and motivate management and other key personnel of the acquired businesses;
- exposure to unforeseen liabilities of acquired companies;
- potential costly and time-consuming litigation, including stockholder lawsuits;
- potential issuance of securities in connection with an acquisition with rights that are superior to the rights of holders of our common stock, or which may have a dilutive effect on our common stockholders;
- the need to incur additional debt or use cash; and
- the requirement to record potentially significant additional future operating costs for the amortization of intangible assets.

As a result of these problems and risks, businesses we acquire may not produce the revenues, earnings or business synergies that we anticipated, and acquired products, services or technologies might not perform as we expected. As a result, we may incur higher costs and realize lower revenues than we had anticipated. We may not be able to successfully address these problems and we cannot assure you that the acquisitions will be successfully identified and completed or that, if acquisitions are completed, the acquired businesses, products, services or technologies will generate sufficient revenue to offset the associated costs or other harmful effects on our business. In addition, our limited operating history with our current structure resulting from recent acquisitions makes it very difficult for you and us to evaluate or predict our ability to, among other things, retain customers, generate and sustain a revenue base sufficient to meet our operating expenses, and achieve and sustain profitability.

A failure to meet customer specifications or expectations could result in lost revenues, increased expenses, negative publicity, claims for damages and harm to our reputation and cause demand for our services to decline. Our agreements with customers require us to meet specified service levels for the services we provide. In addition, our customers may have additional expectations about our services. Any failure to meet customers specifications or expectations could result in:

- delayed or lost revenue;

Table of Contents

requirements to provide additional services to a customer at reduced charges or no charge;

negative publicity about us, which could adversely affect our ability to attract or retain customers; and

claims by customers for substantial damages against us, regardless of our responsibility for the failure, which may not be covered by insurance policies and which may not be limited by contractual terms of our engagement.

Our ability to successfully market our services could be substantially impaired if we are unable to deploy new infrastructure systems and applications or if new infrastructure systems and applications deployed by us prove to be unreliable, defective or incompatible. We may experience difficulties that could delay or prevent the successful development, introduction or marketing of hosting and application management services in the future. If any newly introduced infrastructure systems and 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 significantly reduced. 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 infrastructure systems and applications or enhancements of existing applications, our ability to successfully market our services could be substantially limited.

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 infrastructure systems and applications. We utilize our direct private transit Internet connections to major network providers, such as Level 3, Global Crossing and XO Communications, 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 networks so that our private transit Internet connections operate effectively. If our private transit Internet connections are interrupted or degraded, we may face claims by, or lose, customers, and our reputation in the industry may be harmed, which may cause demand for our services to decline.

If we are unable to maintain existing and develop additional relationships with software vendors, the sales and marketing of our service offerings may be unsuccessful. We believe that to penetrate the market for managed IT services we must maintain existing and develop additional relationships with industry-leading software vendors. We license or lease select software applications from software vendors, including IBM, Microsoft, Micromuse and Oracle. Our relationships with Microsoft and Oracle are critical to the operations and success of our business. The loss of our ability to continue to obtain, utilize or depend on any of these applications or relationships could substantially weaken our ability to provide services to our customers. It may also require us to obtain substitute software applications that may be of lower quality or performance standards or at greater cost. In addition, because we generally license applications on a non-exclusive basis, our competitors may license and utilize the same software applications. In fact, many of the companies with which we have strategic relationships currently have, or could enter into, similar license agreements with our competitors or prospective competitors. We cannot assure you that software applications will continue to be available to us from software vendors on commercially reasonable terms. If we are unable to identify and license software applications that meet our targeted criteria for new application introductions, we may have to discontinue or delay introduction of services relating to these applications.

Our network infrastructure could fail, which would impair our ability to provide guaranteed levels of service and could result in significant operating losses. To provide our customers with guaranteed levels of service, we must operate our network infrastructure 24 hours a day, seven days a week without interruption. We must, therefore, protect our network infrastructure, equipment and customer files against damage from human error, natural disasters, unexpected equipment failure, power loss or telecommunications failures, terrorism, sabotage or other intentional acts of vandalism. Even if we take precautions, the occurrence of a natural disaster, equipment failure or other unanticipated problem at one or more of our data centers could result in interruptions in the services we provide to our customers. We cannot assure you that our disaster recovery plan will address all, or even most, of the problems we may encounter in the event of a disaster or other unanticipated problem. We have experienced service interruptions in the past, and any future service interruptions could:

- require us to spend substantial amounts of money to replace equipment or facilities;
- entitle customers to claim service credits or seek damages for losses under our service level guarantees;
- cause customers to seek alternate providers; or
- impede our ability to attract new customers, retain current customers or enter into additional strategic relationships.

Our dependence on third parties increases the risk that we will not be able to meet our customers needs for software, systems and services on a timely or cost-effective basis, which could result in the loss of customers. Our services and infrastructure rely on products and services of third-party providers. We purchase key components of our infrastructure, including networking equipment, from a limited number of suppliers, such as IBM, Cisco Systems and F5 Networks. Our recently acquired business from Surebridge relies on products and services of Microsoft and Oracle. We cannot assure you that we will not experience operational problems attributable to the installation, implementation, integration, performance, features or functionality of third-party software, systems and services. We cannot assure you that we will have the necessary hardware or parts on hand or that our suppliers will be able to provide them in a timely manner in the event of equipment failure. Our ability to timely obtain and continue to maintain the necessary hardware or parts could result in sustained equipment failure and a loss of revenue due to customer loss or claims for service credits under our service level guarantees.

We could be subject to increased operating costs, as well as claims, litigation or other potential liability, in connection with risks associated with Internet security and the security of our systems. A significant barrier to the growth of e-commerce and communications over the Internet has been the need for secure transmission of confidential information. Several of our infrastructure systems and application services utilize encryption and authentication technology licensed from third parties to provide the protections necessary to ensure secure transmission of confidential information. We also rely on security systems designed by third parties and the personnel in our network operations centers to secure those data centers. Any unauthorized access, computer viruses, accidental or intentional actions and other disruptions could result in increased operating costs. For example, we may incur additional significant costs to protect against these interruptions and the threat of security breaches or to alleviate problems caused by these interruptions or breaches. If a third party were able to misappropriate a consumer s personal or proprietary information, including credit card information, during the use of an application solution provided by us, we could be subject to claims, litigation or other potential liability.

Third-party infringement claims against our technology suppliers, customers or us could result in disruptions in service, the loss of customers or costly and time-consuming litigation. We license or lease most technologies used in the infrastructure systems and application services that we offer. Our technology suppliers may become subject to third-party infringement or other claims and assertions, which could result in their inability or unwillingness to continue to license their technologies to us. We cannot assure you that third parties will not assert claims 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 result in delays in service, installation or upgrades, the loss of customers or costly and time-consuming litigation.

We may be subject to legal claims in connection with the information disseminated through our network, which could divert management s attention and require us to expend significant financial resources. We may face liability for claims of defamation, negligence, copyright, patent or trademark infringement and other claims based on the nature of the materials disseminated through our network. For example, lawsuits may be brought against us claiming that content distributed by some of our customers may be regulated or banned. In these and other instances, we may be required to engage in protracted and expensive litigation that could have the effect of diverting management s attention from our business and require us to expend significant financial resources. Our general liability insurance may not cover any of these claims or may not be adequate to protect us against all liability that may be imposed. In addition, on a limited number of occasions in the past, businesses, organizations and individuals have sent unsolicited commercial e-mails from servers hosted at our facilities to a number of people, typically to advertise products or services. This practice, known as spamming, can lead to statutory liability as well as complaints against service providers that enable these activities, particularly where recipients view the materials received as offensive. We have in the past received, and may in the future receive, letters from recipients of information transmitted by our customers objecting to the transmission. Although we prohibit our customers by contract from spamming, we cannot assure you that our customers will not engage in this practice, which could subject us to claims for damages.

If we fail to attract or retain key officers, management and technical personnel, our ability to successfully execute our business strategy or to continue to provide services and technical support to our customers could be adversely affected and we may not be successful in attracting new customers. We believe that attracting, training, retaining and motivating technical and managerial personnel, including individuals with significant levels of infrastructure systems and application expertise, is a critical component of the future success of our business. Qualified technical personnel are likely to remain a limited resource for the foreseeable future and competition for these personnel is intense. The departure of any of our executive officers, particularly Arthur P. Becker, our Chief Executive Officer and President, or core members of our sales and marketing teams or technical service personnel, would have negative ramifications on our customer relations and operations. The departure of our executive officers could adversely affect the stability of our infrastructure and our ability to provide the guaranteed service levels our customers expect. 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 personnel. Over the past two years, we have had significant reductions-in-force and departures of several members of senior management due to redundancies and restructurings resulting from the consolidation of our acquired companies. In the event of future reductions or departures of employees, our ability to successfully execute our business strategy, or to continue to provide services to our customers or attract new customers, could be adversely affected.

The unpredictability of our quarterly results may cause the trading price of our common stock to fluctuate or decline. Our quarterly operating results may vary significantly from quarter-to-quarter and period-to-period 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 our operating results include the following:

- a reduction of market demand and/or acceptance of our services;
- an 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, which depends on the budgets of our 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 or our hosting operations;
- our ability to meet any increased technological demands of our customers; and
- the amount and timing of costs related to our marketing efforts and service introductions.

Due to the above factors, we believe that quarter-to-quarter or period-to-period comparisons of our operating results may not be a good indicator of our future performance. Our operating results for any particular quarter may fall short of our expectations or those of stockholders or securities analysts. In this event, the trading price of our common stock would likely fall.

If we are unsuccessful in pending and potential litigation matters, our financial condition may be adversely affected. We are currently involved in various pending and potential legal proceedings, including a class action lawsuit related to our initial public offering. If we are ultimately unsuccessful in any of these matters, we could be required to pay substantial amounts of cash to the other parties. The amount and timing of any of these payments could adversely affect our financial condition.

Table of Contents

If the markets for outsourced information technology infrastructure and applications, Internet commerce and communication decline, there may be insufficient demand for our services and, as a result, our business strategy and objectives may fail. The increased use of the Internet for retrieving, sharing and transferring information among businesses and consumers is developing, and the market for the purchase of products and services over the Internet is still relatively new and emerging. Our industry has experienced periods of rapid growth, followed by a sharp decline in demand for products and services, which related to the failure in the last few years of many companies focused on developing Internet-related businesses. If acceptance and growth of the Internet as a medium for commerce and communication declines, our business strategy and objectives may fail because there may not be sufficient market demand for our managed IT services.

If we do not respond to rapid changes in the technology sector, we will lose customers. The markets for the technology-related services we offer are characterized by rapidly changing technology, evolving industry standards, frequent new service introductions, shifting distribution channels and changing customer demands. We may not be able to adequately adapt our services or to acquire new services that can compete successfully. In addition, we may not be able to establish and maintain effective distribution channels. We risk losing customers to our competitors if we are unable to adapt to this rapidly evolving marketplace.

The market in which we operate is highly competitive and is likely to consolidate, 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 managed IT services market. This market is rapidly evolving, highly competitive and likely to be characterized by over-capacity and industry consolidation. Our competitors may consolidate with one another or acquire software application vendors or technology providers, enabling them to more effectively compete with us. Many participants in this market have suffered significantly in the last several years. We believe that participants in this market must grow rapidly and achieve a significant presence to compete effectively. This consolidation could affect prices and other competitive factors in ways that would impede our ability to compete successfully in the managed IT services market.

Further, 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. Many of our competitors may be able to:

- develop and expand their network infrastructure 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; or
- devote greater resources to the marketing and sale of their services and adopt more aggressive pricing policies than we can.

We may lack the financial and other resources, expertise or capability needed to maintain or capture increased market share in this environment in the future. 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 managed IT services market.

Difficulties presented by international economic, political, legal, accounting and business factors could harm our business in international markets. We operate a data center in the United Kingdom. Revenue from our foreign operations accounted for approximately 4.0% of our total revenue during the six months ended January 31, 2006. We recently expanded our operations to India, which could eventually broaden our customer service support. Although we expect to focus most of our growth efforts in the United States, we may enter into joint ventures or outsourcing agreements with third parties, acquire complementary businesses or operations, or establish and maintain new operations outside of the United States. Some risks inherent in conducting business internationally include:

unexpected changes in regulatory, tax and political environments;

longer payment cycles and problems collecting accounts receivable;

geopolitical risks such as political and economic instability and the possibility of hostilities among countries or terrorism;

reduced protection of intellectual property rights;

fluctuations in currency exchange rates or imposition of restrictive currency controls;

our ability to secure and maintain the necessary physical and telecommunications infrastructure;

challenges in staffing and managing foreign operations;

employment laws and practices in foreign countries;

laws and regulations on content distributed over the Internet that are more restrictive than those currently in place in the United States; and

significant changes in immigration policies or difficulties in obtaining required immigration approvals.

Any one or more of these factors could adversely affect our international operations and consequently, our business.

We may become subject to burdensome government regulation and legal uncertainties that could substantially harm our business or expose us to unanticipated liabilities. It is likely that laws and regulations directly applicable to the Internet or to hosting and managed application service providers may be adopted. These laws may cover a variety of issues, including 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 growth of our business or expose us to unanticipated liabilities. Moreover, the applicability of existing laws to the Internet and hosting and managed application 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 provide services over the Internet in many states in the United States and elsewhere and facilitate the activities of our customers in these 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, employees or property in those states.

The price of our common stock has been volatile, and may continue to experience wide fluctuations. Since January 2004, our common stock has closed as low as $1.19 per share and as high as $7.30 per share. The trading price of our common stock has been and may continue to be subject to wide fluctuations due to the risk factors discussed in this section and elsewhere in this report. Fluctuations in the market price of our common stock may cause an investor in our common stock to lose some or all of his investment. In addition, should the market price of our common stock be below $1.00 per share for an extended period, or if we fail to satisfy any other Nasdaq continued listing requirement, Nasdaq may delist our common stock, which would have an adverse effect on the trading of our common stock. On June 10, 2002, the listing of our common stock transferred from the Nasdaq National Market to the Nasdaq Capital Market because the market price of our common stock had failed to maintain compliance with the Nasdaq National Market s minimum $1.00 per share continued listing requirement. A delisting of our common stock from Nasdaq could materially reduce the liquidity of our common stock and result in a corresponding material reduction in the price of our common stock. Also, a delisting would be a default under our convertible promissory notes issued to Waythere. In addition, a delisting could harm our ability to raise capital through alternative financing sources on terms acceptable to us, or at all, and may result in the potential loss of confidence by suppliers, customers and employees. On April 7, 2005, we received a letter from the Nasdaq Listing Qualifications Staff stating that we had not paid certain Nasdaq fees as required by Nasdaq Marketplace

Table of Contents

Rule 4310(c)(13) and that as a result, our common stock was subject to delisting from the Nasdaq Capital Market. On April 8, 2005, we paid these outstanding fees in full and received a letter from Nasdaq confirming compliance with Marketplace Rule 4310(c)(13). We also confirmed with Nasdaq that no further action by us was required and that our common stock will continue to be listed on the Nasdaq Capital Market.

Anti-takeover provisions in our corporate documents may discourage or prevent a takeover. Provisions in our certificate of incorporation and our by-laws may have the effect of delaying or preventing an acquisition or merger in which we are acquired or a transaction that changes our Board of Directors. These provisions:

authorize the board to issue preferred stock without stockholder approval;

prohibit cumulative voting in the election of directors;

limit the persons who may call special meetings of stockholders; and

establish advance notice requirements for nominations for the election of directors or for proposing matters that can be acted on by stockholders at stockholder meetings.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

We do not enter into financial instruments for trading purposes. We do not use derivative financial instruments or derivative commodity instruments in our investment portfolio or enter into hedging transactions. Our exposure to market risk associated with risk-sensitive instruments entered into for purposes other than trading purposes is not material to NaviSite. We currently have no significant foreign operations and therefore face no material foreign currency exchange rate risk.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures. Based on management s evaluation (with the participation of NaviSite s principal executive officer and principal financial officer) as of the end of the period covered by this report, NaviSite s principal executive officer and principal financial officer have concluded that NaviSite s disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended, (the Exchange Act)) are effective to ensure that information required to be disclosed by NaviSite in reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms, and that the information is accumulated and communicated to its management, including to its principal executive officer and principal financial officer as appropriate to allow timely decisions regarding required disclosure.

Changes in Internal Control Over Financial Reporting. There was no change in NaviSite s internal control over financial reporting during the second fiscal quarter that has materially affected, or is reasonably likely to materially affect, NaviSite s 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. The suit 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 alleges specifically that Robertson Stephens, in exchange for the allocation to its customers of shares of our common stock sold in our initial public offering, solicited and received from its customers agreements to purchase additional shares of our common stock in the aftermarket at pre-determined prices. The suit seeks unspecified monetary damages and certification of a plaintiff class consisting of all persons who acquired shares of our common stock between October 22, 1999 and December 6, 2000. Three 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), and Binh Nguyen (filed July 10, 2001). Robert E. Eisenberg, our president at the time of the initial public offering in 1999, also was named as a defendant in the Nguyen lawsuit.

On or about June 21, 2001, David Federico filed in the United States District Court for the Southern District of New York a lawsuit against us, Mr. Rosen, Mr. Hale, Robertson Stephens and other 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. The suit generally alleges that the defendants violated the anti-trust laws and the federal securities laws by conspiring and agreeing to raise and increase the compensation received by the underwriter defendants by requiring those who received allocation of initial public offering stock to agree to purchase shares of manipulated securities in the after-market of the initial public offering at escalating price levels designed to inflate the price of the manipulated stock, thus artificially creating an appearance of demand and high prices for that stock, and initial public offering stock in general, leading to further stock offerings. The suit also alleges that the defendants arranged for the underwriter defendants to receive undisclosed and excessive brokerage commissions and that, as a consequence, the underwriter defendants successfully increased investor interest in the manipulated initial public offering of securities and increased the underwriter defendants individual and collective underwritings, compensation, and revenue. The suit further alleges that the defendants violated the federal securities laws by issuing and selling securities pursuant to the initial public offering without disclosing to investors that the underwriter defendants in the offering, including the lead underwriters, had solicited and received excessive and undisclosed commissions from certain investors. The suit seeks unspecified monetary damages and certification of a plaintiff class consisting of all persons who acquired shares of our common stock between October 22, 1999 and June 12, 2001.

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 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 and against us and Messrs. Rosen, Hale and Eisenberg (collectively, the NaviSite Defendants). 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. 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. In connection with the Preliminary Approval Order, the Court scheduled a Fed. R. Civ. P. 23 fairness hearing for April 24, 2006 in order to consider whether to enter final approval of the settlement. Any requests for exclusion or objections to the settlement are to be filed by March 24, 2006. 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 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 more than 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 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.

Wrongful Termination Claim

This lawsuit for wrongful termination was filed in the Superior Court of the State of California, Santa Clara County (Case No. 104CV031471) against NaviSite, Inc. and one of its former employees. Plaintiffs were two female former employees of NaviSite who were terminated from their employment in 2004 as part of a reduction in force. One plaintiff alleged unlawful discrimination based on age and gender, and the other plaintiff alleged unlawful discrimination based on gender and retaliation for taking maternity leave. NaviSite s management and the co-named former employee denied all claims and vigorously defended the lawsuit. On November 1, 2005, NaviSite entered into a settlement agreement with both of the plaintiffs, pursuant to which NaviSite is required to make an aggregate payment of $500,000, payable over time. As of July 31, 2005, we had accrued $500,000 for this settlement, of which we have paid $300,000 in the second quarter and $100,000 in the third quarter of fiscal year 2006. The balance, as of January 31, 2006, is included in Accrued expenses and other current liabilities on our Consolidated Balance Sheet.

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

At the 2005 Annual meeting of Stockholders of the Company (the Annual Meeting) held on December 8, 2005, 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 28, 2005 was 28,487,260. The results of the voting on each of the matters presented to stockholders at the Annual Meeting are set forth below:

	Votes For	Votes Withheld	Votes Against	Abstentions	Broker Non-Votes
Election of six members of the board of directors:					
Andrew Ruhan	21,512,718	65,581	N/A	N/A	N/A
Arthur P. Becker	21,512,450	65,849	N/A	N/A	N/A
Gabriel Ruhan	21,511,418	66,881	N/A	N/A	N/A
James H. Dennedy	21,566,568	11,731	N/A	N/A	N/A
Larry W. Schwartz	21,565,450	12,849	N/A	N/A	N/A
Thomas R. Evans	21,566,638	11,661	N/A	N/A	N/A
Ratification of Independent Registered Public Accounting Firm	21,572,915	N/A	3,243	2,141	

Item 6. Exhibits

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

Table of Contents

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 15, 2006	NAVISITE, INC.
	By: /s/ John J. Gavin, Jr.
	John J. Gavin Jr.
	(Principal Financial and Accounting Officer)

Table of Contents

EXHIBIT INDEX

Exhibit Number	Description
10.1	Letter from Atlantic Investors, LLC dated as of January 31, 2006 is incorporated herein by reference to Exhibit 99.1 to the Registrant s Current Report on Form 8-K filed on March 10, 2006 (File No. 000-27597).
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.