NAVISITE INC
Form 10-Q
December 15, 2003

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

Form 10-Q

(Mark One)

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

For the quarterly period ended October 31, 2003

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

(978) 682-8300

(Registrant s telephone number, including area code)

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 an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes o No þ

As of December 12, 2003, there were 24,691,476 shares outstanding of the registrant s common stock, par value $.01 per share.

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PART I. FINANCIAL INFORMATION

Item 1. ***Financial Statements***

NAVISITE, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

	October 31, 2003	July 31, 2003
	(Unaudited) (In thousands, except par value)	
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 2,898	$ 3,862
Accounts receivable, less allowance for doubtful accounts of $1,847 and $2,030 at October 31, 2003 and July 31, 2003, respectively	17,218	14,741
Due from related parties	125	
Prepaid expenses and other current assets	4,674	4,011
Total current assets	24,915	22,614
Property and equipment, net	20,039	22,165
Customer lists, less amortization of $4,571 and $3,724 at October 31, 2003 and July 31, 2003, respectively	11,181	12,052
Goodwill	3,206	3,206
Other assets	6,069	6,280
Restricted cash	2,182	3,054
Total assets	$ 67,592	$ 69,371
LIABILITIES AND STOCKHOLDERS EQUITY		
Current Liabilities:		
Accounts receivable financing line, net	$ 9,269	$ 6,358
Current notes payable	1,181	1,211
Capital lease obligations, current portion	2,927	3,268
Current note payable to related party	3,000	3,000
Accounts payable	4,122	4,371
Accrued expenses	16,316	17,580
Deferred revenue	2,722	2,993
Customer deposits	129	134
Total current liabilities	39,666	38,915
Capital lease obligations, less current portion	1,541	1,907
Accrued restructuring, less current portion	3,933	3,476
Note to AppliedTheory estate	6,000	6,000
Other long-term liabilities	2,111	2,194
Total liabilities	53,251	52,492
Commitments and contingencies (note 10)		
Stockholders equity:		

Preferred Stock, $0.01 par value. Authorized 5,000 shares; no shares issued or outstanding at October 31, 2003 and July 31, 2003		
Accumulated other comprehensive income (loss)	15	(16)
Common Stock, $0.01 par value. Authorized 395,000 shares; issued and outstanding 24,691 and 23,412 at October 31, 2003 and July 31, 2003	248	235
Additional paid-in capital	435,934	432,399
Accumulated deficit	(421,856)	(415,739)
Total stockholders equity	14,341	16,879
Total liabilities and stockholders equity	$ 67,592	$ 69,371

See accompanying notes to interim consolidated financial statements.

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NAVISITE, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

	Three Months Ended October 31,	
	2003	**2002**
	(Unaudited) (In thousands, except per share)	
Revenue:		
Revenue	$23,473	$ 14,561
Revenue, related parties		1,310
Total revenue	23,473	15,871
Cost of revenue	17,924	16,495
Impairment and restructuring	633	
Total cost of revenue	18,557	16,495
Gross profit, (loss)	4,916	(624)
Operating expenses:		
Product development	348	382
Selling and marketing	1,972	1,287
General and administrative	4,958	3,677
Impairment and restructuring	456	
Total operating expenses	7,734	5,346
Loss from operations	(2,818)	(5,970)
Other income (expense):		
Interest income	64	305
Interest expense	(609)	(3,940)
Other income (expense), net	10	(400)
Net loss	$ (3,353)	$(10,005)
Basic and diluted net loss per common share	$ (0.14)	$ (1.60)
Basic and diluted weighted average number of common shares outstanding	24,506	6,270

See accompanying notes to interim consolidated financial statements.

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NAVISITE, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

	Three Months Ended October 31,	
	2003	**2002**
	(Unaudited) (In thousands)	
Cash flows from operating activities:		
Net loss	$ (3,353)	$ (10,005)
Adjustments to reconcile net loss to net cash used for operating activities:		
Depreciation and amortization	3,484	3,350
Amortization of beneficial conversion feature to interest expense		1,773
Interest on debt paid in stock		276
Other non-cash interest expense	260	
Impairment and restructuring	1,088	
Loss on disposal of assets		166
Provision for doubtful accounts	(183)	141
Changes in operating assets and liabilities, net of impact of acquisitions:		
Accounts receivable	(2,294)	(516)
Due from related parties	(125)	1,479
Prepaid expenses and other current assets, net	(663)	51
Other long-term liabilities	(83)	103
Deposits	516	
Accounts payable	(248)	(256)
Other assets		35
Customer deposits	(5)	31
Accrued expenses and deferred revenue	(1,613)	(294)
Net cash used for operating activities	(3,219)	(3,666)
Cash flows from investing activities:		
Purchase of property and equipment, net	(486)	(196)
Purchase of debt securities		(1,963)
Proceeds from the sale of equipment		307
Restricted cash	872	(32)
Net cash provided by (used for) investing activities	386	(1,884)
Cash flows from financing activities:		
Proceeds from issuance of common stock		1,990
Repayment of note payable		(4,631)
Net borrowings under accounts receivable line	2,606	
Payments under note to affiliates	(30)	
Payment of capital lease obligations	(707)	(475)
Net cash provided by (used for) financing activities	1,869	(3,116)
Net decrease in cash	(964)	(8,666)
Cash and cash equivalents, beginning of quarter	3,862	22,379
Cash and cash equivalents, end of quarter	$ 2,898	$ 13,713

Supplemental disclosure of cash flow information:

Cash paid during the period for:		
Interest	$ 273	$ 1,473

See accompanying notes to interim consolidated financial statements.

NAVISITE, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

October 31, 2003 and 2002, and July 31, 2003
(Unaudited)

1. Description of Business

NaviSite, Inc. provides outsourced hosting, co-location and managed application services for mid-sized enterprises, divisions of large multi-national companies, government agencies and other businesses conducting mission critical business on the Internet. Substantially all revenues are generated from customers in the United States.

2. Significant Accounting Policies

(a) Basis of Presentation

The accompanying interim consolidated financial statements have been prepared by NaviSite, Inc. (NaviSite, we, us or our) in accordance with accounting principles generally accepted in the United States of America and pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such rules and regulations. It is suggested that the interim consolidated financial statements be read in conjunction with the audited consolidated financial statements and the accompanying notes included in our Annual Report on Form 10-K which was filed with the Securities and Exchange Commission on October 22, 2003.

The information furnished reflects all adjustments, which, in the opinion of management, are of a normal recurring nature and are considered necessary for a fair presentation of results for the interim periods. Such adjustments consist only of normal recurring items. It should be noted that results for interim periods are not necessarily indicative of the results expected for the full year or any future period.

The preparation of these interim consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities on the date of the financial statements and the reported amounts of revenues and expenses during the reporting period.

One-for-fifteen Reverse Stock Split

On December 12, 2002, our board of directors, pursuant to authority previously granted by our stockholders at the annual meeting on December 19, 2001, approved a reverse stock split of our common stock at a ratio of one-for-fifteen (1:15) effective January 7, 2003. All per-share amounts and number of shares outstanding have been restated to give effect to the reverse stock split.

Impact of Acquisitions

On August 8, 2003, we completed the acquisition of certain assets and the assumption of certain liabilities of ClearBlue Technologies, Inc. (CBT) pursuant to a Stock and Asset Acquisition Agreement (the CBT Agreement). We acquired all outstanding shares of six (6) wholly-owned subsidiaries of CBT with data centers located in Chicago, Las Vegas, Los Angeles, Milwaukee, Oakbrook and Vienna. In addition, we assumed the revenue and expense, as of the date of acquisition, of four (4) additional wholly-owned subsidiaries of CBT with data centers located in Dallas, New York, San Francisco and Santa Clara. Ownership of these subsidiaries will automatically be transferred, under certain conditions, to NaviSite for no additional consideration in February 2004. The operational results of these four subsidiaries have been included herein since NaviSite exercised effective control over these subsidiaries as of August 8, 2003.

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NAVISITE, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

As Atlantic Investors, LLC had a controlling interest in both NaviSite and CBT at the time of the combination, the transaction was accounted for as a combination of entities under common control (i.e., as if pooling) whereby the assets and liabilities of CBT and NaviSite were combined at their historical amounts. Accordingly, the Company s consolidated financial statements have been restated for all periods prior to the business combination to include the financial results back to the date on which CBT acquired the controlling interest in the Company (September 11, 2002) after the elimination of intercompany balances as identified in our 8K/ A filing on October 22, 2003. CBT s balance sheet has been included in the Consolidated Balance Sheet of NaviSite at October 31, 2003 and July 31, 2003, and CBT s results of operations and cash flows for the three months ended October 31, 2003 have been included in the Consolidated Statement of Operations and Consolidated Statement of Cash Flows of NaviSite for the three month period ended October 31, 2003 and CBT s results of operations for the two month period ended October 31, 2002 have been included in our Consolidated Statements of Operations for the three month period ended October 31, 2002. See Note 6 for further discussion of our fiscal year 2003 and 2004 acquisitions.

(b) Principles of Consolidation

The accompanying consolidated financial statements include the accounts of NaviSite and our wholly-owned subsidiaries, ClickHear, Inc., NaviSite Acquisition Corp., ClearBlue Technologies Management, Inc., Avasta, Inc., Conxion Corporation, Intrepid Acquisition Corp., ClearBlue Technologies/ Chicago-Wells, Inc., ClearBlue Technologies/ Las Vegas, Inc., ClearBlue Technologies/ Los Angeles, Inc., ClearBlue Technologies/ Milwaukee, Inc., ClearBlue Technologies/ Oakbrook, Inc., and ClearBlue Technologies/ Vienna, Inc. after elimination of all significant intercompany balances and transactions.

(c) Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect certain 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 revenues and expenses during the reporting periods. 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 and the collectibility of receivables.

(d) Cash and Cash Equivalents

Cash equivalents consist of a money market fund, which invests in high quality short-term debt obligations, including commercial paper, asset-backed commercial paper, corporate bonds, U.S. government agency obligations, taxable municipal securities, and repurchase agreements.

(e) Revenue Recognition

Revenue consists of monthly fees for Web site and Internet application management, application rentals, hosting, co-location, and professional services. Revenue (other than installation fees) is generally billed and recognized over the term of the contract, generally one to three years, based on actual usage. Payments received in advance of providing services are deferred until the period such services are provided. Revenue from professional services is recognized on a time-and-material basis as the services are performed or under the percentage of completion method for revenue relating to fixed-price contracts. We generally sell our professional services under contracts with terms ranging from one to five years. Revenue and profits on long-term Internet solutions contracts, which represent approximately 2% of total revenues for the three-month period ended October 31, 2003, performed over extended periods are principally recognized under the percentage-of-completion method of accounting with adjustments recorded in the period in which the

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NAVISITE, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

revisions are made. Any anticipated losses on contracts are charged to operations as soon as they are determinable.

(f) Concentrations of Credit Risk

Our financial instruments include cash, accounts receivable, obligations under capital leases, software agreements, accounts payable, and accrued expenses. As of October 31, 2003, the carrying cost of these instruments approximated their fair value. Financial instruments that potentially subject us to concentration of credit risk consist primarily of accounts receivable. Concentrations of credit risk with respect to trade receivables are limited due to the large number of customers across many industries that comprise our customer base. One third-party customer accounted for 15% and 23% of our total revenues for the three-month period ended October 31, 2003 and October 31, 2002, respectively. Accounts receivable at October 31, 2003 include approximately $2.4 million due from this third-party customer.

(g) Comprehensive Income (Loss)

Comprehensive income (loss) is defined as the change in equity from foreign currency translation adjustments.

(h) Goodwill and Intangible Assets

At October 31, 2003 and July 31, 2003, our intangible assets consisted of customer lists resulting from our acquisition of CBTM, and the acquisitions of the certain assets and liabilities of Interliant and CBT. Our intangible assets were recorded at a gross carrying value of $15.8 million, less accumulated amortization of $4.6 million and $3.7 million at October 31, 2003 and July 31, 2003, respectively. Amortization expense related to our lists of $0.8 million for the three-month period ended October 31, 2003 was recorded as a component of our cost of revenue. Goodwill, resulting from our acquisition of CBTM, is recorded at its gross carrying value of $3.2 million. The company performs its annual impairment analysis in its fiscal fourth quarter.

(i) Accounting for Impairment of Long-Lived Assets

We assess the need to record impairment losses on long-lived assets used in operations when indicators of impairment are present. On an ongoing basis, management reviews the value and period of amortization or depreciation of long-lived assets. During this review, the significant assumptions used in determining the original cost of long-lived assets are reevaluated. Although the assumptions may vary from transaction to transaction, they generally include revenue growth, operating results, cash flows, and other indicators of value. Management then determines whether there has been a permanent impairment of the value of long-lived assets by comparing future undiscounted cash flows to the asset s carrying value. If the estimated future undiscounted cash flows are less than the carrying value of the asset, a loss is recorded based on the excess of the asset s carrying value over fair value.

(j) Income Taxes

We account for income taxes under the asset and liability method. 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.

NAVISITE, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(k) Net Loss Per Common Share

Basic earnings (loss) per share is computed using the weighted average number of common shares outstanding during the period. Diluted earnings (loss) per share is computed using the weighted average number of common and dilutive common equivalent shares outstanding during the period using the as-if-converted method for convertible notes payable or the treasury stock method for options, unless such amounts are anti-dilutive.

For the three months ended October 31, 2003 and 2002, 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 loss. For the three months ended October 31, 2003 and 2002, 40,200 and 4,168, respectively, of dilutive shares related to employee stock options were excluded as they had an anti-dilutive effect due to the net loss. (see note 11)

(l) Stock-Based Compensation

We account for our stock option plans under the recognition and measurement principles of APB Opinion No. 25, Accounting for Stock Issued to Employees, and Related Interpretations. No stock-based compensation cost is reflected in net income (loss) for these plans, as all options granted under these plans had an exercise price equal to the market value of the underlying common stock on the date of grant. The following table illustrates the effect on net loss and loss per share if we had applied the fair value recognition provisions of FASB Statement No. 123, Accounting for Stock Based Compensation, to stock based compensation (in thousands, except per share data):

	For the Three Months Ended October 31,	
	2003	**2002**
Net Loss, as reported	$(3,353)	$(10,005)
Add: stock based employee compensation expense determined under fair value based method for all awards, net of related tax effects	$ (921)	$ (3,316)*
Net loss, as adjusted	$(4,274)	$(13,321)
Loss per share:		
Basic and diluted as reported	$ (0.14)	$ (1.60)
Basic and diluted as adjusted	$ (0.17)	$ (2.12)

* Includes $13,259 related to CMGI Options. After the change of control on September 11, 2002, all outstanding CMGI options issued to NaviSite employees were canceled.

The fair value of each stock option is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions:

	For the Three Months Ended October 31,	
	2003	**2002**

NaviSite:		
Risk-free interest rate	2.26%	2.25%
Expected dividend yield	0.00%	0.00%
Expected volatility	172.56%	171.47%
Expected life (years)	3.02	3.02
Weighted average fair value of options granted during the period	$ 3.53	$ 2.36

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NAVISITE, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(m) Segment reporting

We currently operate in one segment, outsourced hosting and application management services.

(n) New Accounting Pronouncements

In January 2003, the FASB issued Interpretation No. 46 (FIN 46), Consolidation of Variable Interest Entities (VIEs). This Interpretation addresses the consolidation of variable interest entities in which the equity investors lack one or more of the essential characteristics of a controlling financial interest or where the equity investment at risk is not sufficient for the entity to finance its activities without subordinated financial support from other parties. The Interpretation applies to VIEs created after January 31, 2003 and to VIEs in which an interest is acquired after that date. Effective January 31, 2004, it also applies to VIEs in which an interest is acquired before February 1, 2003. The Company may apply the Interpretation prospectively with a cumulative effect adjustment as of January 31, 2004, or by restating previously issued financial statements with a cumulative effect adjustment as of the beginning of the first year presented. In October 2003, the FASB issued FASB Staff Position, or FSP 46-6, Effective Date of FASB Interpretation 46, Consolidation of Variable Interest Entities. This FSP deferred the effective date for applying the provisions of FIN 46 for interests in variable interest entities or potential variable interest entities created before February 1, 2003. This statement delayed the effective date of FIN 46 for the Company until the quarter ending January 31, 2004. The Company is currently evaluating the applicability of the requirements of FIN 46.

In May 2003, the FASB issued SFAS No. 150, Accounting For Certain Financial Instruments with Characteristics of Both Liabilities and Equity , which establishes standards for how an issuer of financial instruments classifies and measures certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances) if, at inception, the monetary value of the obligation is based solely or predominantly on a fixed monetary amount known at inception, variations in something other than the fair value of the issuer s equity shares or variations inversely related to changes in the fair value of the issuer s equity shares. This Statement is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. On November 7, 2003 the FASB deferred the classification and measurement provisions of SFAS No. 150 as they apply to certain mandatory redeemable non-controlling interests. This deferral is expected to remain in effect while these provisions are further evaluated by the FASB. The Company has not entered into or modified any financial instruments covered by this statement after May 31, 2003 and the application of this standard is not expected to have a material impact on the Company s financial position or results of operations.

(o) Reclassifications

Certain fiscal year 2003 balances have been reclassified to conform with the fiscal year 2004 financial statement presentation.

(p) Foreign Currency

The functional currencies of our wholly-owned subsidiaries are the local currencies. The financial statements of the subsidiaries are translated into U.S. dollars using period-end exchange rates for assets and liabilities and average exchange rates during corresponding period for revenues, cost of revenues and expenses. Translation gains and losses are deferred and accumulated as a separate component of stockholders equity (accumulated other comprehensive income (loss)).

NAVISITE, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

3. Liquidity

Our cash and cash equivalents decreased to approximately $2.9 million at October 31, 2003 from approximately $3.9 million at July 31, 2003. Net cash used in operating activities was approximately $3.2 million for the period ended October 31, 2003, resulting primarily from net losses, increases in accounts receivable, decreases in accrued expenses and deferred revenue partially offset by depreciation, amortization and non-cash impairment charges. Net cash provided by investing activities was approximately $0.4 million for the period ended October 31, 2003, resulting primarily from reductions of restricted cash offset by purchases of property and equipment. Net cash provided by financing activities was approximately $1.9 million for the period ended October 31, 2003, resulting primarily from borrowings from our accounts receivable financing line partially offset by repayment of capital lease obligations.

At October 31, 2003, we had a working capital deficit of $14.8 million, an accumulated deficit of $422 million, and have reported losses from operations since incorporation. We anticipate incurring additional losses throughout our current fiscal year. We have taken several actions we believe will allow us to continue as a going concern through July 31, 2004, including the closing and integration of strategic acquisitions, the change in our Board of Directors and senior management and bringing costs more in line with projected revenues. Based upon our cash flow estimates we believe that we will more than likely need to raise funds to meet our anticipated needs for working capital and capital expenditures for the remainder of fiscal year 2004. 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 Silicon Valley Bank 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 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.

We believe that we will more than likely need to raise funds through the issuance of equity or convertible debt securities, or through credit arrangements with financial institutions. If we are required to raise money in the future and we experience difficulty doing so, our business will be materially adversely affected. The accompanying consolidated financial statements have been prepared assuming NaviSite will continue as a going concern and, as such, do not include any adjustments that may result from the outcome of these uncertainties.

4. Intangible Assets

Intangible assets as of October 31, 2003 are as follows:

	Gross Carrying Amount	Accumulated Amortization
Customer Lists	$15,752	$4,571

Intangible asset amortization expense for the three-month period ended October 31, 2003 and 2002 aggregated $847 and $530, respectively. The amount reflected in the table below for fiscal year 2004 includes

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NAVISITE, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

year-to-date amortization. Amortization expense related to intangible assets for the next five years is as follows:

Year Ending July 31, 2004	$3,338
2005	$3,060
2006	$2,737
2007	$1,787
2008	$1,027

5. 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. 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.

Property and equipment at October 31, 2003 and July 31, 2003 are summarized as follows:

	October 31, 2003	July 31, 2003
	(In thousands)	
Office furniture and equipment	$ 2,614	$ 2,613
Computer equipment	28,694	28,368
Software licenses	9,343	9,308
Leasehold improvements	12,689	12,549
	53,340	52,838
Less accumulated depreciation and amortization	(33,301)	(30,673)
Property and equipment, net	$ 20,039	$ 22,165

6. Acquisitions

CBTM. We acquired CBTM in December 2002 in a transaction accounted for as a combination of entities under common control (i.e., as if pooling). In June 2002, prior to our acquisition of CBTM, CBTM acquired substantially all of the assets used or useful in the web hosting and Internet solutions business and assumed certain associated liabilities from the bankruptcy estate of AppliedTheory Corporation (AppliedTheory), which had filed for bankruptcy on April 17, 2002. On June 13, 2002, the acquisition of AppliedTheory by CBTM was consummated, effective June 6, 2002. The results of operations of AppliedTheory have been included in the financial statements of CBTM since June 6, 2002.

The aggregate purchase price paid by CBTM for the AppliedTheory assets, excluding assumed liabilities, was $16.0 million of which $3.9 million was paid in cash and $12.1 million was paid with the issuance of four notes payable to the AppliedTheory Estate: two unsecured promissory notes totaling $6.0 million, bearing interest at 8% per annum and due June 10, 2006, a secured promissory note totaling $700,000, bearing interest at 8% per annum and due December 10, 2002 and a $5.4 million secured promissory note, non-interest bearing, due December 10, 2002. The two notes due December 10, 2002 were paid in December 2002.

Of the $6.2 million in identifiable intangible assets, $5.8 million was assigned to customer lists which are being amortized over eight years, except for the New York State Department of Labor customer contract, which is being amortized over five years, and represented the remaining life on the contract. The remaining

NAVISITE, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

$440,000 of acquired intangible assets was allocated to proprietary software, which is being amortized over five years.

Avasta, Inc. On February 5, 2003, we acquired Avasta, a provider of remote hosting and managed service operations, in an all-stock transaction valued at approximately $370,000. The acquisition was made to enhance our ability to be a full service provider of applications management services and technology to our customers. The purchase price consisted of 231,039 shares of common stock at a per share value of $1.60 (representing a five-day average of the market value of our common stock at the time of the acquisition). The purchase price of $442,000 consists of the issuance of common stock for approximately $370,000 and approximately $72,000 in acquisition costs. The Agreement and Plan of Merger provided that up to an additional 1,004,518 shares of common stock could be issued in the event certain revenue targets were achieved through June 2003. As a result of the earnout calculation, in September 2003 we issued 179,353 shares of our common stock at a per share value of $4.14 (representing the market value of our common stock the day preceding the issuance of the additional shares for the attainment of certain revenue targets). The negative goodwill of approximately $342,000 reduced the recorded basis of property and equipment. This acquisition was accounted for using the purchase method of accounting.

Conxion Corporation. On April 2, 2003, we completed the acquisition of Conxion, a provider of software distribution services and network/server security expertise for its customers, pursuant to an Agreement and Plan of Merger, dated as of March 26, 2003 (Conxion Agreement), by and between us, Union Acquisition Corp., a Delaware corporation and our wholly-owned subsidiary and Conxion. Pursuant to the Conxion Agreement, the shareholders of Conxion received an aggregate of $1,925,000 in cash. The acquisition was made to enhance our ability to be a full service provider of applications management services and technology to our customers. The source of funds used for the acquisition of Conxion was our cash on hand. The acquisition price was based on the parties determination of the fair value of Conxion and the terms of the Conxion Agreement were derived from arms-length negotiation among the parties. The purchase price of $2,031,000 consisted of the $1,925,000 paid to the Conxion shareholders and approximately $106,000 in acquisition costs. The negative goodwill of approximately $2.5 million reduced the recorded basis of property and equipment. This acquisition was accounted for using the purchase method of accounting.

Interliant. On May 16, 2003, we completed the acquisition of substantially all of the assets relating to the managed infrastructure solutions business, encompassing messaging and collaboration, managed hosting, bundled-in managed security, and integrated and related professional services in the United States and in Europe of Interliant, Inc., a Delaware corporation, and several of its subsidiaries (Debtors) in the bankruptcy proceedings of the Debtors under Chapter 11 of Title 11 of the United States Bankruptcy Code pending in the Southern District of New York (White Plains), pursuant to an Asset Purchase Agreement, dated as of May 15, 2003 (the Agreement), by and between our subsidiary, Intrepid Acquisition Corp. and the Debtors, approved by order of the Bankruptcy Court on May 15, 2003. Pursuant to the Agreement, the aggregate purchase price for the Interliant assets was approximately $7,204,000 after adjustments, based upon the Debtors adjusted net worth, comprised of approximately $5,830,000 in cash, $624,000 in the form of a credit of future distributions to be paid on the Interliant Notes, $550,000 in principal amount of a non-interest bearing, 180-day promissory note, secured by the Interliant Debt and approximately $200,000 in acquisition-related costs. On May 16, 2003, our subsidiary closed on the purchase of all of the Interliant Assets, other than the Debtors accounts receivable. On June 6, 2003 our subsidiary closed on the purchase of the accounts receivable. The source of funds used for the initial closing was our cash on hand combined with the funds provided from and through financing of our accounts receivable with Silicon Valley Bank (SVB), as discussed below, cash acquired with the Interliant assets, and cash receipts from the purchased accounts receivable. The acquisition price was determined through arms-length negotiations and competitive bidding for the Interliant Assets at an auction conducted under the auspices of the Bankruptcy Court. Final purchase accounting may be adjusted pending resolution of a net worth calculation as defined in the asset purchase agreement, however we do not expect that this adjustment will be material. (see note 9)

NAVISITE, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

ClearBlue Technologies. On August 8, 2003, we completed the acquisition of certain assets and the assumption of certain liabilities of CBT pursuant to a Stock and Asset Acquisition Agreement (the CBT Agreement). Pursuant to the CBT Agreement, we acquired all outstanding shares of six (6) wholly-owned subsidiaries of CBT with data centers located in Chicago, Las Vegas, Los Angeles, Milwaukee, Oakbrook and Vienna.

In addition, we assumed the revenue and expense, as of the date of the CBT Agreement, of four (4) additional wholly-owned subsidiaries of CBT with data centers located in Dallas, New York, San Francisco and Santa Clara. Ownership of these subsidiaries will automatically be transferred, under certain conditions, to us for no additional consideration in February 2004.

In exchange for these subsidiaries and certain assets and contracts relating to them, we: (i) issued 1.1 million shares of our common stock, to CBT; (ii) released CBT from certain inter-company advances in an amount up to $300,000; (iii) assumed all of CBT s obligations under certain assets and contracts relating to the these subsidiaries; and (iv) released CBT from certain payment obligations owed to us pursuant to the Outsourcing Agreement in an amount not to exceed $263,000.

As Atlantic Investors, LLC had a controlling interest in both NaviSite and CBT at the time of the combination, the transaction was accounted for as a combination of entities under common control (i.e., as if pooling) whereby the assets and liabilities of CBT and NaviSite were combined at their historical amounts. Accordingly, the Company s consolidated financial statements have been restated for all periods prior to the business combination to include the financial results back to the date on which CBT acquired the controlling interest in the Company (September 11, 2002). CBT s balance sheet has been included in the Consolidated Balance Sheet of NaviSite at October 31, 2003 and July 31, 2003, and CBT s results of operations and cash flows for the three months ended October 31, 2003 have been included in the Consolidated Statement of Operations and Consolidated Statement of Cash Flows of NaviSite for the three month period ended October 31, 2003, and CBT s results of operations for the two month period ended October 31, 2002 have been included in our Consolidated Statement of Operations for the three month period ended October 31, 2002.

The following unaudited results of operations for the three-months ended October 31, 2003 and unaudited pro forma results for the three-month period ended October 31, 2002 give effect to our acquisitions of CBT and CBTM, which were accounted for as as if poolings and to CBTM s acquisition of AppliedTheory assets as if the transactions had occurred at the beginning of fiscal year 2002. The pro forma information does not necessarily reflect the results of operations that would have occurred had the acquisitions taken place at the beginning of the fiscal 2002 period and is not necessarily indicative of results that may be obtained in the future. (In thousands, except per share amounts)

	For the Three Months Ended October 31,	
	Actual 2003	**Pro Forma 2002**
	(In thousands)	
Revenue	$23,473	$ 32,714
Net loss	(3,353)	(15,450)
Pro forma net loss per share	$ (0.14)	$ (2.46)

7. 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 million. Interliant is a provider of managed services, which filed a petition under Chapter 11 of the United States Bankruptcy Code in the Southern District of New York 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 Southern District of New York (White Plains) confirmed us as the successful bidder for the purchase of the Interliant assets. The final value we will receive for the Interliant Notes has not been determined, however, we estimate the value to approximate the $1.4 million carrying value, included in other assets on our Consolidated Balance Sheet. The Interliant Estate has filed a plan of liquidation with the bankruptcy court which is subject to creditor approval and resolution of contested claims.

8. Accrued Expenses

Accrued expenses consist of the following at October 31, 2003 and July 31, 2003, respectively.

	October 31, 2003	July 31, 2003
	(In thousands)	
Accrued payroll, benefits, commissions	$ 2,651	$ 3,088
Accrued accounts payable	3,671	3,694
Accrued interest	536	351
Due to AppliedTheory Estate	1,461	1,461
Accrued contract termination fees	850	2,096
Accrued lease exit costs	2,785	2,536
Accrued taxes	933	708
Accrued other	3,429	3,646
Total accrued expenses	$16,316	$17,580

9. Debt

(a) Accounts Receivable Financing Agreement

On May 26, 2003, we entered into an Accounts Receivable Financing Agreement (Financing Agreement) with Silicon Valley Bank (SVB) whereby we can finance up to a maximum of $12.5 million of our eligible accounts receivables with an 80% advance rate. Under the Financing Agreement, we are required to repay advances upon the earlier of our receipt of payment on the financed accounts receivables from our customers, or the financed accounts receivable being aged greater than ninety days from date of service. The Financing Agreement has a one-year term and bears an annual interest rate of prime rate plus 4.0%, with a minimum $10,000 monthly finance charge. The Financing Agreement also contains certain affirmative and negative covenants and is secured by substantially all of our assets, tangible and intangible. As part of the Financing Agreement, on May 27, 2003 we issued to SVB warrants to purchase up to 165,000 shares of NaviSite common stock with an exercise price of $2.50, the closing price of our stock on the last business day before the issuance of the warrant. We fair valued the warrants at $370,000 using the Black-Scholes option-pricing model. The value of the warrants is being amortized into interest expense over the term of the Financing Agreement. At October 31, 2003, we had approximately $9.5 million outstanding under the Financing Agreement, which represented the maximum borrowings under the Financing Agreement at that time. The outstanding amount under the Financing Agreement is shown net of the unamortized amount of the warrants on our Consolidated Balance Sheets.

NAVISITE, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

On January 29, 2003, we entered into a $10 million Loan and Security Agreement (Atlantic Loan) with Atlantic, a related party. The Atlantic Loan has a termination date of February 1, 2004 and 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 due to Atlantic by NaviSite. 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, but not such that the payment would be required before February 1, 2004. Atlantic can demand payment of the Minimum Loan Amount with 90 days notice, but not such that payment would be required before August 1, 2003. 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 related party 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 NaviSite 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 October 31, 2003, 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.

(c) Note Payable to AppliedTheory Estate

As part of CBTM s acquisition of certain AppliedTheory assets, CBTM entered into a long-term liability of $6.0 million (Estate Liability) due to the AppliedTheory Estate in June 10, 2006. The Estate Liability bears interest at 8% per annum, which is due and payable annually. At October 31, 2003, we had approximately $200,000 in accrued interest related to this note.

(d) Notes Payable to the Interliant Estate

As part of our acquisition of certain Interliant Assets, we entered into a promissory note with the Interliant Estate (Interliant Promissory Note) in the amount of $550,000, payable without interest on the earlier of (i) the 180th day following the Second Closing Date or (ii) the date Interliant estates make distributions to their general unsecured creditors. The Interliant Promissory Note is secured by the Interliant Notes. Pursuant to the terms of the Asset Purchase Agreement between Intrepid and Interliant, each party placed $300,000 in escrow as security for adjustments in the purchase price based upon changes in Interliant s net worth at the time of the closing. The parties have reached a verbal understanding, subject to final documentation, that will result in a $325,000 purchase price adjustment in favor of Intrepid. Intrepid s $550,000 promissory note in favor of Interliant will be satisfied out of the net worth adjustment and the remaining balance of $225,000 will be paid from funds Intrepid placed in escrow.

10. Commitments and Contingencies

(a) Leases

Abandoned Leased Facilities. On January 31, 2003, we abandoned our administrative space on the second floor of our 400 Minuteman Road, Andover, MA leased location. We continue to maintain and operate our Data Center on the first floor of the building. While we remain obligated under the terms of the lease for the rent and other costs associated with the second floor of the building, we ceased to use the space on January 31, 2003 and have no foreseeable plans to occupy the second floor in the future. Therefore, in accordance with SFAS 146, Accounting for Costs Associated with Exit or Disposal Activities, issued in July 2002, we recorded a charge to our earnings in fiscal year 2003 of approximately $5.4 million to recognize the costs of exiting the space. The liability is equal to the total amount of rent and other direct costs for the period

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NAVISITE, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

of time the second floor of the building was expected to remain unoccupied plus the present value of the amount by which the rent paid by us to the landlord exceeds any rent paid to us by a tenant under a sublease over the remainder of the lease term, which is May 2011.

Near the end of our fiscal year 2002, we abandoned our sales office space in La Jolla, CA. At that time we were able to sublet the space to a third party. During the second quarter of fiscal year 2003, the sublease tenant stopped making payments under the sublease and has abandoned the space. The facility is currently empty and we remain obligated under the terms of the lease for the rent and other costs associated with the building. We have no foreseeable plans to occupy the space, therefore, under SFAS 146, we recorded a charge to our earnings of approximately $1.4 million during fiscal year 2003 to recognize the costs of exiting the building.

In October 2003, we abandoned administrative office space at 55 Francisco St. San Francisco, California and data center space and office space located at Westwood Center, Vienna, Virginia. While we remain obligated under the terms of these leases for the rent and other costs associated with these leases, we have made the decision to cease using these spaces on October 31, 2003 and have no foreseeable plans to occupy them in the future. Therefore, in accordance with SFAS 146, Accounting for Costs Associated with Exit or Disposal Activities, issued in July 2002, we recorded a charge to our current earnings in the first quarter of fiscal year 2004 of approximately $1.1 million to recognize the costs of exiting the space. The amount is included in the caption Impairment and restructuring in the accompanying Consolidated Statements of Operations. The liability is equal to the total amount of rent and other direct costs for the period of time space is expected to remain unoccupied plus the present value of the amount by which the rent paid by us to the landlord exceeds any rent paid to us by a tenant under a sublease over the remainder of the lease terms, which expire in January 2006 and July 2005, respectively.

Details of activity in the lease exit accrual for the period ended October 31, 2003 were as follows (in thousands):

	Balance at July 31, 2003	Payments	Adjustments	Balance at October 31, 2003
		(In thousands)		
400 Minuteman Lease abandonment costs	$3,340	$(350)	$	$2,990
La Jolla Lease abandonment costs	1,109	(56)		1,053
Chicago & Virginia Lease abandonment costs	1,399	10		1,409
Amsterdam Lease abandonment costs	164	2		166
Vienna Lease abandonment costs		11	633	644
55 Francisco Lease abandonment costs			456	456
	$6,012	$(383)	$1,089	$6,718

We are obligated under various capital and operating leases for facilities and equipment.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Minimum annual rental commitments under operating leases and other commitments are as follows as of October 31, 2003 (in thousands):

Description	Total	Less than 1 Year	1-3 Years	4-5 Years	After 5 Years
Short/ Long-term debt	$ 19,031	13,031	6,000		
Interest on debt	1,613	653	960		
Capital leases	4,927	3,386	1,541		
Operating leases	1,034	834	200		
Bandwidth commitments	5,329	2,661	2,026	642	
Maintenance for hardware/software	1,188	1,188			
Property leases	$ 84,682	13,482	25,467	19,150	26,583
	117,804	35,235	36,194	19,792	26,583

(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 underwritings,

NAVISITE, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

compensation, and revenues. 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.

We believe that the allegations against us are without merit and we intend to vigorously defend against the plaintiffs claims. We are not able to predict the possible outcome of the suits and their ultimate effect, if any, on our financial condition.

Goldman Sachs Payment Demand

In March 2001, we engaged Goldman Sachs & Co. to serve as our financial advisor in connection with the possible sale of all or a portion of NaviSite. On September 17, 2002, Goldman made a written demand for payment of a $3 million success fee in connection with the September 2002 acquisition by CBT of the stock and convertible debt of NaviSite from CMGI and Hewlett-Packard Financial Services Company. We have rejected Goldman s demands, as we believe they are without merit. No legal actions have been filed concerning the Goldman claim. As this matter is in the initial stage, we are not able to predict the possible outcome of this matter and the effect, if any, on our financial condition.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Joseph Cloonan

On or about September 27, 2002, we received a demand for a wage payment of $850,000 from our former Procurement Director, Joseph Cloonan. We rejected the demand, alleging that Mr. Cloonan s claim is based, among other things, on a potentially fraudulent contract. Mr. Cloonan also claimed $40,300 for allegedly unpaid accrued vacation and bonuses and that he may be statutorily entitled to treble damages and legal fees. On October 11, 2002, NaviSite filed a civil complaint with the Massachusetts Superior Court, Essex County, seeking a declaratory judgment and asserting claims against Mr. Cloonan for civil fraud, misrepresentation, unjust enrichment and breach of duty of loyalty. Mr. Cloonan asserted counter claims against NaviSite seeking the payments set forth in his September 2002 demand. We believe Mr. Cloonan s allegations are without merit and intend to vigorously defend against them. As the litigation is in the initial discovery stage, we are not able to predict the possible outcome of this matter and the effect, if any, on our financial condition.

Lighthouse International

On October 28, 2002, CBTM, one of our subsidiaries, filed a complaint in United States District Court for the Southern District of New York against Lighthouse International, alleging six causes of action for copyright infringement, breach of contract, account stated, unjust enrichment, unfair competition, and misappropriation and/or conversion. The total claimed damages are in the amount of $1,866,450. On or about January 16, 2003, Lighthouse filed and served its answer and counterclaimed against CBTM claiming $3,130,000 in damages and $5,000,000 in punitive relief.

On June 17, 2003, the U.S. Bankruptcy Court for the Southern District of New York heard oral argument on Lighthouse s Motion for an Order Compelling the Debtor (AppliedTheory) to Assume or Reject an Agreement, filed in response to CBTM s. complaint, and the objections to Lighthouse s motion filed by CBTM and AppliedTheory. Lighthouse made this motion on the basis that it never received notice of CBTM assuming the AppliedTheory contract for the LighthouseLink Web site. The Bankruptcy Court declined to grant Lighthouse s motion, and instead ordered that an evidentiary hearing be conducted to determine whether Lighthouse received appropriate notice of the proposed assignment of the contract by AppliedTheory to CBTM. The Bankruptcy Court ordered that the parties first conduct discovery, and upon completion of discovery, which is expected to be completed on or about the end of January 2004, the Bankruptcy Court would schedule an evidentiary hearing on the issue of notice.

As to the U.S. District Court matter, the exchange of written discovery is near completion, with a number of discovery disputes to be resolved by the Court in October 2003 at a discovery status conference. All depositions of witnesses have been stayed pending completion of the Bankruptcy Court evidentiary hearing. Because of the continuing discovery, and the uncertain outcome of the evidentiary hearing before the Bankruptcy Court, we are not able to predict the possible outcome of this matter, if any, on our financial condition.

Avasta Earnout

On October 14, 2003, we received a letter purportedly on behalf of the former stockholders of Avasta relating to the issuance of additional shares of common stock pursuant to the earnout calculations pursuant to the Agreement and Plan of Merger and Reorganization dated as of January 29, 2003 among Avasta Corp., Avasta, Inc. and NaviSite. On December 11, 2003, a demand for arbitration before JAMS was filed claiming among other things breach of contract, tortious conduct, fraud and other wrongful conduct. Damages sought include in excess of 691,538 shares of NaviSite common stock. As this matter is in the initial stage, we are not able to predict the possible outcome of this matter and the effect, if any, on our financial condition.

NAVISITE, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

La Jolla Landlord

On November 24, 2003, U.S. Property Fund GmbH & Co, the landlord for space leased by NaviSite in La Jolla, California, filed a breach of lease action against NaviSite. The landlord claims damages in excess of $2,000,000. As this matter is in the initial stage, we are not able to predict the possible outcome of this matter and the effect, if any, on our financial condition.

11. Stockholders Equity

On December 12, 2002, CBT cancelled warrants to purchase 346,883 shares of our common stock at exercise prices ranging from $86.55 to $103.80 per share.

The 567,978 shares issued to CBT on December 31, 2002 in connection with the acquisition of CBTM have been accounted for by us as a dividend distribution to CBT because CBT and its affiliates are considered to have controlling interest over both CBTM and NaviSite. As a result, we reported an increase to accumulated deficit of $1,277,950, which represents the number of common shares issued at the then current market value of $2.25 per share.

On February 5, 2003, we issued 231,039 shares of our common stock at a per share value of $1.60 in connection with the acquisition of Avasta (see Note 6). In September 2003 we issued 179,353 shares of our common stock at a per share value of $4.14 (representing the market value of our common stock the day preceding the issuance of the addition shares) for the attainment of certain revenue targets in conjunction with the Avasta acquisition.

On August 8, 2003, we issued 1,100,000 shares of our common stock to CBT at a per share value of $2.55 in connection with the acquisition of certain assets of CBT (see Note 6). The issuance of these shares has been accounted for as a dividend distribution because Atlantic Investors, LLC and its affiliates are considered to have controlling interest in both CBT and NaviSite. As a result, we reported a reduction of retained earnings of $2,805,000 which represents the number of common shares issued at the then current market value of $2.55 per share.

12. Related Party Transactions

For the period August 1, 2002 through September 11, 2002, we classified revenue from CMGI and CMGI affiliates as revenue from related parties. For all periods subsequent to September 12, 2002, we classified revenue from CMGI and CMGI affiliates as third-party revenue.

The consolidated financial statements for the three-month period ended October 31, 2002, include certain allocations from CMGI for certain general and administrative expenses, such as rent, legal services, insurance, and employee benefits. Allocations are based primarily on headcount. Management believes that the method used to allocate the costs and expenses is reasonable; however, such allocated amounts may or may not necessarily be indicative of what actual expenses would have been incurred had we operated independently of CMGI. As a result of CMGI s sale of its debt and equity interests in us, the agreement between NaviSite and CMGI whereby CMGI provided certain services for us automatically terminated. CMGI continued to provide certain services to us pursuant to a Transition Services Agreement we entered into with CMGI on November 25, 2002, as we transitioned to services agreements with CBT and to other third-party suppliers. This transition agreement concluded during the second quarter of fiscal year 2003 and we have completely severed our administrative ties with CMGI; however, CMGI remains a third-party customer. During the second quarter of fiscal year 2003, we contracted with CBT and other third-party suppliers for these services. We currently rent administrative facilities from CMGI at 800 Federal Street, Andover, Massachusetts.

On December 31, 2002, CBTM was required to pay a $6.1 million liability owed to the AppliedTheory Estate as a result of CBTM s acquisition of AppliedTheory. In order to fund the $6.1 million payment, CBTM entered

NAVISITE, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

into a $6.0 million line of credit with Unicorn Worldwide Holding Limited (Unicorn), a related party to NaviSite and CBTM. CBTM drew down $4.6 million and together with cash on hand at December 31, 2002, paid the $6.1 million liability due to the AppliedTheory Estate. In January 2003, CBTM paid $2.6 million of the $4.6 million due to Unicorn, leaving a liability to Unicorn of $2.0 million at January 31, 2003. In January 2003, we entered into a Loan and Security Agreement with Atlantic and in February 2003, drew down on this facility to pay off the remaining $2.0 million due Unicorn by CBTM. CBTM has a long-term liability of $6.0 million (Estate Liability) due to the AppliedTheory Estate on June 10, 2006. (see note 9)

On January 29, 2003, we entered into a $10 million Loan and Security Agreement (Atlantic Loan) with Atlantic, a related party. The Atlantic Loan has a termination date of February 1, 2004 and 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 due to Atlantic by NaviSite. 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, but not such that the payment would be required before February 1, 2004. Atlantic can demand payment of the Minimum Loan Amount with 90 days notice, but not such that payment would be required before August 1, 2003. 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 related party 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 NaviSite does not exceed the maximum loan amount, defined as the lesser of $10.0 million or 65% of our consolidated accounts receivables. At October 31, 2003 and July 31, 2003, we had $3.0 million outstanding under the Atlantic Loan and had approximately $500,000 available to us. This amount is shown as a current note payable to related party on our Consolidated Balance Sheet. The Atlantic Loan is secured by all of our 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.

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, Inc. provides outsourced hosting, co-location and managed application services for mid-sized enterprises, divisions of large multi-national companies, government agencies and other businesses conducting mission critical business on the Internet. Our goal is to help customers focus on their core competencies by outsourcing the hosting and management of their operations and applications, allowing customers to improve the efficiency of their operations. Our focus on Managed Application Services (A-Services), Managed Infrastructure Services (I-Services) and Managed Messaging Services (M-Services) allows us to meet the expanding needs of our customers as their applications become more complex.

NAVISITE, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NaviSite operates 14 data centers in the United States and one data center in the United Kingdom. We combine a highly scalable and developed infrastructure with expertise, experience, intellectual property, software platforms, processes and procedures for delivering simple to complex hosting and application management services. We provide a combination of high availability infrastructure, high performance monitoring systems, and proactive problem resolution and change management processes designed to recognize patterns and identify and address potentially crippling problems before they are able to cause downtime in customers operations. The price for our services varies from customer to customer based on the number of managed servers and the nature, extent and level of services provided. Customers typically enter into agreements with a term of one to three years with monthly payment installments.

On September 11, 2002, CMGI and Hewlett-Packard Financial Services Company each sold and transferred to ClearBlue Technologies, Inc., a privately-held managed service provider based in San Francisco, California, and certain affiliated entities, all of their equity and debt interests in NaviSite, resulting in ClearBlue Technologies becoming NaviSite s majority stockholder.

The audit report on our fiscal year 2003 consolidated financial statements from KPMG LLP, our independent auditors, contains an explanatory paragraph that states that our recurring losses since inception and accumulated deficit, as well as other factors, raise substantial doubt about our ability to continue as a going concern. During fiscal year 2003 and thereafter, we have undergone a significant transition, including all of the acquisitions that are described in this report and a balance sheet restructuring, to position ourselves among the leaders in the hosting and managed applications services market. Included in this transition was a complete turnover of our senior management team and our Board of Directors. While we cannot assure you that we will continue as a going concern, as part of our transition efforts we believe that we have developed and are implementing an operational plan that will bring costs more in line with projected revenue growth.

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Results of Operations

The following table sets forth the percentage relationships of certain items from the Company s consolidated condensed statements of operations as a percentage of Total Revenue.

	Three Months Ended October 31,	
	2003	**2002**
	(In thousands, except per share and share data)	
Revenue:		
Revenue	100.0%	91.7%
Revenue, related parties	0.0%	8.3%
Total revenue	100.0%	100.0%
Cost of revenue	76.4%	103.9%
Impairment and restructuring	2.7%	0.0%
Total cost of revenue	79.1%	103.9%
Gross profit (deficit)	20.9%	(3.9)%
Operating expenses:		
Product development	1.5%	2.4%
Selling and marketing	8.4%	8.1%
General and administrative	21.1%	23.2%
Impairment and restructuring	1.9%	0.0%
Total operating expenses	32.9%	33.7%
Loss from operations	(12.0)%	(37.6)%
Other income (expense):		
Interest income	0.3%	1.9%
Interest expense	(2.6)%	(24.8)%
Other income (expense), net	0.0%	(2.5)%
Net loss	(14.3)%	(63.0)%

Revenue

We derive our revenue primarily from outsourced managed hosting, co-location and application services comprised of a variety of service offerings, including providing related professional and consulting services, to mid-sized enterprises, divisions of large multi-national companies and government agencies. Revenue for the three-month period ended October 31, 2002 contains two months of revenue from CBTM and CBT.

Total revenue for the three-month period ended October 31, 2003 increased 48% to approximately $23.5 million from approximately $15.9 million for the same period in fiscal year 2003. The overall growth in revenue of $7.6 million was mainly due to revenue resulting from our fiscal 2003 acquisitions, which contributed approximately $9.1 million in revenue during the quarter ended October 31, 2003. The increased revenue was partially offset by lost customer revenue of $1.6 mainly the result of a decrease in revenue from related parties of $1.3 million. Revenue from related parties principally consisted of sales of services to CMGI and its affiliates until September 11, 2002 when CMGI sold its equity and debt interests in NaviSite. The

NAVISITE, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

decrease in related party revenue was primarily attributable to CMGI and its affiliates terminating their relationships with NaviSite upon the completion of their contracts.

Gross Profit

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

Cost of revenue for the three-month period ended October 31, 2003, excluding impairment charges, increased 9% to approximately $17.9 million from approximately $16.5 million for the same period in fiscal year 2003. The increase in the cost of revenue of $1.4 million, net of impairment charges, resulted primarily from costs incurred to deliver the increase in revenue for the period.

Gross profit for the three-month period ended October 31, 2003 was 20.9% as compared to a gross deficit of 3.9% for the same period in fiscal year 2003. Excluding the impairment charge recorded this quarter, our gross profit was 23.6%. This increase was mainly due to reductions in unit costs of the expenses used to deliver our revenues such as Internet connectivity charges, equipment costs and related depreciation and costs to run our data centers as well as our ability to deliver the increase in revenue with no significant increase in overall salary expense. The Company expects gross margins to continue to improve with further increases in sales levels.

Operating Expenses

Product Development. Product development expenses consist primarily of salaries and related costs. Product development expenses decreased 9% to approximately $348,000 for the three-month period ended October 31, 2003 from approximately $382,000 from the same period in fiscal year 2003. The decrease in product development expenses is primarily related to severance costs recorded in the three-month period ended October 31, 2002 which were not replicated in the same period in fiscal year 2003.

Selling and Marketing. Selling and marketing expenses consist primarily of salaries and related benefits, commissions and marketing expenses such as advertising, product literature, trade shows, marketing and direct mail programs. Selling and marketing expense increased 53% for the three-month period ended October 31, 2003 to approximately $2.0 million from approximately $1.3 million for the same period in fiscal year 2003. The increase of approximately $685,000 resulted primarily from an increase in salary and related costs, an increase in commission expense as a result of the increase in revenue and an increase in marketing program costs.

General and Administrative. General and administrative expenses include the costs of financial, leasing, human resources, IT and administrative personnel, professional services, bad debt and corporate overhead. Also included in the three-month period ended October 31, 2002 are intercompany charges from CMGI for facilities and shared back office and business development support. These costs were eliminated upon the termination of the Facilities and Administrative Agreement between CMGI and us in September 2002. Excluding the impairment charge, general and administrative expenses increased 35% to approximately $5.0 million for the three-month period ended October 31, 2003 from approximately $3.7 million for the same period in fiscal year 2003. The increase of approximately $1.3 million was mainly the result of increases in salary expense of approximately $580,000, bad debt expense of approximately $340,000, utility expense of approximately $300,000, depreciation expense of approximately $290,000 and costs of moving data centers of approximately $125,000 partially offset by decreases in the allocation of expense from CMGI of approximately $250,000 and legal expenses of approximately $160,000.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Impairment and Restructuring

Costs associated with impairment, restructuring and abandonment of lease facilities increased to approximately $1.1 million for the three-month period ended October 31, 2003 compared to no expense for the same period in fiscal year 2003. The increase is due primarily to abandonment of data center space at our Vienna, Virginia facility, recorded as an increase to cost of sales and the abandonment of administrative space at our 55 Francisco Street, San Francisco, California office recorded as an increase to general and administrative. We recorded a charge equal to the amount of rent and other direct costs for the period and time the space is expected to remain unoccupied plus the present value of the amount by which the rent paid by us to the landlord exceeds any rent paid to us by a subtenant under a sublease over the remainder of the lease term.

Interest Income

Interest income decreased 79% to approximately $64,000 for the three-month period ended October 31, 2003 from approximately $305,000 for the same period in fiscal year 2003. The decrease is due primarily to lower cash balances during the three-month period ended October 31, 2003 as compared to the same period in fiscal year 2003.

Interest Expense

Interest expense decreased 84% to approximately $609,000 for the three-month period ended October 31, 2003 from $3.9 million for the same period in fiscal year 2003. The decrease is due primarily to the reduction of the expense related to the beneficial conversion feature and interest on the convertible debt, which was fully converted in fiscal year 2003.

Other Income (expense), net

Other income (expense), net increased to approximately $10,000 for the three-month period ended October 31, 2003 from approximately ($400,000) for the same period in fiscal year 2003.

Critical Accounting Policies

We prepare our consolidated financial statements in accordance with accounting principles generally accepted in the United States of America. As such, management is required to make certain estimates, judgments and assumptions that they believe 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. The Company believes these estimates are reasonable, but actual results could differ from these estimates.

Revenue Recognition. We provide outsourced hosting, co-location and managed application services and related professional and consulting services. Revenue consists of monthly fees for Web site and Internet application management, application rentals, and hosting. Revenues related to monthly fees for Web site and Internet application management, application rentals and hosting are recognized over the term of the customer contract based on actual usage and services. Revenue from professional services is recognized on a time-and-materials basis as the services are performed or under the percentage-of-completion method for revenue related to fixed-price contracts. Revenue and profits on long-term Internet solutions contracts, performed over extended periods, are recognized under the percentage-of-completion method of accounting,

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

principally based on direct labor dollars. Revenues and profits on long-term contracts are based on our estimates to complete and are reviewed periodically, with adjustments recorded in the period in which the revisions are made. Any anticipated losses on contracts are charged to operations as soon as they are determinable. Fees charged for the installation of customer equipment are generally received in advance and are deferred and recognized as revenue over the life of the related customer contract, typically 12 to 36 months. In the event a customer terminates the agreement prior to its stated maturity, all deferred revenue related to installation services is automatically recognized upon the effective date of the termination, and we generally charge cancellation or termination fees that are also recognized upon the effective date of the termination. Cancellation fees are calculated as the customer s remaining base monthly fees obligation times the number of months remaining in the contract term.

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. This method historically approximated actual write off experience. 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, primarily 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 such 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.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Liquidity and Capital Resources

Our cash and cash equivalents decreased to approximately $2.9 million at October 31, 2003 from approximately $3.9 million at July 31, 2003. Net cash used in operating activities was approximately $3.2 million for the period ended October 31, 2003, resulting primarily from net losses, increases in accounts receivable, decreases in accrued expenses and deferred revenue partially offset by depreciation, amortization and non cash impairment charges. Net cash provided by investing activities was approximately $0.4 million for the period ended October 31, 2003, resulting primarily from reductions of restricted cash offset by purchases of property and equipment. Net cash provided by financing activities was approximately $1.9 million for the period ended October 31, 2003, resulting primarily from borrowings from our accounts receivable financing line partially offset by repayment of capital lease obligations.

At October 31, 2003, we had a working capital deficit of $14.8 million, an accumulated deficit of $422 million, and have reported losses from operations since incorporation. We anticipate incurring additional losses throughout our current fiscal year. We have taken several actions we believe will allow us to continue as a going concern through July 31, 2004, including the closing and integration of strategic acquisitions, the change in our Board of Directors and senior management and bringing costs more in line with projected revenues. Based upon our cash flow estimates we believe that we will more than likely need to raise funds to meet our anticipated needs for working capital and capital expenditures for the remainder of fiscal year 2004. 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 Silicon Valley Bank 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 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.

We believe that we will more than likely need to raise funds through the issuance of equity or convertible debt securities, or through credit arrangements with financial institutions. If we are required to raise money in the future and we experience difficulty doing so, our business will be materially adversely affected. The accompanying consolidated financial statements have been prepared assuming NaviSite will continue as a going concern and, as such, do not include any adjustments that may result from the outcome of these uncertainties.

Certain 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 document 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 or earnings or concerning projected 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 there can be no assurance 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. The risks and uncertainties described below are not the only risks we face. Additional risks and uncertainties not presently known to us or currently deemed immaterial may also impair our business operations. If any of the following risks actually occurs, our financial condition and operating results could be materially adversely affected.

We have a history of losses and may never achieve profitability and may not continue as a going concern. Since our incorporation in 1998, we have experienced operating losses and negative cash flows for each

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

quarterly and annual period. As of October 31, 2003, we had approximately $2.9 million of cash and cash equivalents, a working capital deficit of approximately $14.8 million and had incurred losses since our incorporation resulting in an accumulated deficit of approximately $422 million. During the fiscal quarter ended October 31, 2003, we had a net loss of approximately $3.4 million. 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, machinery 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 will be materially adversely affected.

Our available cash, combined with the funds available to us under the Silicon Valley Bank financing agreement, may not be sufficient to meet our needs through the end of fiscal year 2004. In addition, the financing agreement with Silicon Valley Bank includes various covenants and restrictions that may affect our ability to operate our business. To the extent that we are not able to comply with the covenants and restrictions, we may be unable to borrow additional amounts and outstanding amounts may become due on an accelerated basis, which would adversely affect our liquidity. Further, we will more than likely need to raise additional funds to remain a going concern. Our projections for cash usage are based on a number of assumptions, including: (i) our ability to retain customers in light of market uncertainties and our uncertain future; (ii) our ability to collect accounts receivables in a timely manner; (iii) our ability to effectively integrate recent acquisitions and realize forecasted cash savings synergies; and (iv) our ability to achieve expected other cash expense reductions. Further, our projected use of cash and business results could be affected by continued market uncertainties, including delays or restrictions in IT spending and any merger or acquisition activity. Accordingly, we will more than likely need to raise additional funds to continue as a going concern and such funds may not be available or may not be available on favorable terms.

In recent years, we have generally financed our operations with proceeds from selling shares of our stock and borrowing funds. There can be no assurance that we will be able to sell any such securities or borrow funds in the future at favorable terms or at all. In addition, even if we find outside funding sources, we may be required to issue to such outside sources securities with greater rights than those currently possessed by holders of our common stock. We may also be required to take other actions, which may lessen the value of our common stock or dilute our common stockholders, including borrowing money on terms that are not favorable to us or issuing additional equity securities. If we are required to raise money in the future and we experience difficulties doing so, our business will be materially adversely affected.

A significant portion of our revenue comes from one customer and, if we lost this customer, it would have a significant adverse impact to our business results and cash flow. The New York State Department of Labor, a customer of CBTM, one of our wholly-owned subsidiaries which, in June 2002, acquired certain assets from the bankrupt estate of AppliedTheory, Inc., represented approximately 26% and 15% of our consolidated revenue for the fiscal year ended July 31, 2003 and fiscal quarter ended October 31, 2003, respectively. Although the New York State Department of Labor has been a long-term customer of CBTM, we cannot guarantee that we will be able to retain this customer or to maintain the same level of services to or revenue from such customer. This contract with the New York State Department of Labor expires in June 2005, provided, however, the New York State Department of Labor has the right to terminate the contract 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. The loss of a significant amount of business with this customer, or any other key customer, would have a material adverse effect on our business, financial condition and results of operations. We believe that we will continue to derive the vast majority of our operating revenue from sales to a small number of customers.

Atlantic Investors and its affiliates, collectively, own a majority of our outstanding common stock and may have interests that conflict with the interests of our other stockholders. At October 29, 2003, Atlantic

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Investors and its affiliates owned, directly or indirectly, approximately 72% of the outstanding capital stock of NaviSite, as reported on Schedule 13D/A by Atlantic Investors, LLC on August 28, 2003. In addition, Atlantic Investors holds a promissory note issued by NaviSite in the principal amount of $3.0 million. In addition, Atlantic Investors has the power, acting alone, to elect a majority of our Board of Directors and has the ability to determine the outcome of any corporate action requiring stockholder approval, regardless of how our other stockholders may vote. Under Delaware law, Atlantic Investors is able to exercise its voting power by written consent, without convening a meeting of the stockholders, which means that Atlantic Investors could effect a sale or merger of NaviSite without the consent of our other 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 NaviSite or discouraging a potential acquiror from attempting to obtain control of us, which in turn could adversely affect the market price of our common stock.

Some of the members of our management group also serve as members of the management group of Atlantic Investors and its affiliates. As a result, these NaviSite officers and directors may face potential conflicts of interest. Specifically, these NaviSite officers and directors may be presented with situations in their capacity as officers or directors of NaviSite that conflict with their fiduciary obligations to Atlantic Investors or to another subsidiary or affiliate. Atlantic Investors may have interests that conflict with the interests of our other stockholders.

Integration of acquisitions may result in disruptions to our business or distractions of our management due to difficulties in integrating and assimilating acquired personnel and operation, and such integrations may not proceed as planned. On December 31, 2002, we acquired CBTM. On February 4, 2003, we acquired Avasta. On April 2, 2003, we acquired Conxion. On May 16, 2003, we acquired the Interliant Assets. On August 8, 2003, we acquired all of the shares of six (6) wholly-owned subsidiaries of CBT and the revenues and expenses of four (4) additional wholly-owned subsidiaries. In order to successfully integrate the operations, products and people of CBTM, Avasta, Conxion, certain former wholly-owned subsidiaries of CBT and the Interliant Assets, we will have to devote a significant amount of management resources. Integrating and assimilating acquired operations, technologies and personnel and changes in management or other key personnel may prove difficult and may harm relationships with our customers and employees. We cannot assure you that the combined businesses, assets or technologies will generate sufficient revenue to offset the associated costs or other adverse effects. In addition, these businesses may not produce the revenues, cash savings, earnings or business synergies that we anticipated, and an acquired product, service or technology might not perform as we expected. As a result, we may incur higher costs, and realize lower revenues than we had anticipated.

Our strategy of expanding our business through acquisitions of other businesses and technologies presents special risks. We intend to continue to expand our business through the acquisition of businesses, technologies, products and services from other businesses. Acquisitions involve a number of special problems and risks, including:

- difficulty integrating acquired technologies, operations and personnel with the existing businesses;
- 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 management and other key personnel of the acquired businesses;
- changes in management and key personnel of acquired businesses may harm relationships with the acquired businesses customers and employees;
- exposure to unforeseen liabilities of acquired companies;

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- increased risk of 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 the 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.

We may not be able to successfully address these problems. Moreover, our future operating results will depend to a significant degree on our ability to successfully integrate acquisitions and manage operations and cross-sell our service offerings while also controlling expenses and cash burn. We cannot assure you that the acquisitions will be successfully identified and completed or that, if one or more acquisitions are completed, the acquired business, assets or technologies will generate sufficient revenue to offset the associated costs or other adverse effects.

If the market for Internet commerce and communication does not continue, or it decreases, 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 has developed only recently, and the market for the purchase of products and services over the Internet is still relatively new and emerging. If acceptance and growth of the Internet as a medium for commerce and communication does not continue or decreases, our business strategy and objectives may fail because there may not be sufficient market demand for our hosting and application management services. Our growth will be substantially impaired if the market for hosting and application management services fails to continue to develop or if we cannot continue to achieve broad market acceptance.

Our customer base includes a significant number of small start-up businesses that face increased risk of loss of funding depending upon the availability of private and/or public funding. Many of our customers are small start-up businesses that have traditionally been initially funded by venture capital firms and then through public securities offerings. If the market for small start-up businesses is not supported by the private investors who have funded these customers, we face the risk that these customers may cease, curtail or limit operations hosted by us. We have experienced and may continue to experience a loss of revenue associated with these customers and will then have to increase sales to other businesses using the Internet in order to preserve and grow our revenue.

A failure to meet customer expectations could result in lost revenues, increased expenses, negative publicity and claims for damages. Any failure to meet customers specifications or expectations, could result in:

- delayed or lost revenue;
- requirements to provide additional services to a customer at reduced or no charge;
- negative publicity about NaviSite, which could adversely affect our ability to attract or retain customers; and
- claims by customers for substantial damages against NaviSite, regardless of our responsibility for such failure, which may not be covered by insurance policies and which may not be limited by contractual terms of their engagement.

Our ability to successfully market our services could be substantially impaired if we are unable to deploy new Internet applications or if new Internet applications deployed by us prove to be unreliable, defective or incompatible. We may experience difficulties that could delay or prevent the successful development,

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

To succeed, we must respond to the rapid changes in the technology sector. The markets for the technology-related products and services we offer are characterized by rapidly changing technology, evolving industry standards, frequent new service introductions, shifting distribution channels and changing customer demands. Our success will depend on our ability to adapt to this rapidly evolving marketplace. 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.

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

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

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

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

NAVISITE, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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 Internet application 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.

We depend on third-party software, systems and services. We rely on products and services of third-party providers in our business operations. There can be no assurance that we will not experience operational problems attributable to the installation, implementation, integration, performance, features or functionality of such third-party software, systems and services. Any interruption in the availability or usage of the products and services provided by third parties could have a material adverse effect on our business, financial condition or results of operations.

We purchase key components of our infrastructure, including networking equipment, from a limited number of suppliers. 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 obtain and continue to maintain the necessary hardware or parts on a timely basis 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. Our ability to meet the needs of a substantial number of customers while maintaining superior performance is largely unproven. If our network infrastructure is not scalable, we may not be able to provide our services to additional customers, which would result in no increase in, and may decrease, revenue.

Our decision to discontinue our practice in June 2003, on a prospective basis, of obtaining equipment under leases and subsequently renting the equipment to our customers may have a material adverse effect on our business, future condition and business operations. New customers and current customers seeking to renew their agreements will have to obtain equipment directly from equipment vendors. We may not be successful in attracting new customers who prefer to obtain equipment from their service providers. Current customers may not renew their agreements, but rather, may seek a hosting provider who would also rent equipment directly to them to satisfy their equipment needs. If we are unable to keep our current customers and attract new customers due to our discontinuation of obtaining equipment, our business, financial condition and results of operations could be materially adversely affected.

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 per day, seven days per week without interruption. In order to operate in this manner, we must 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 such a disaster. 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 under our service level guarantees, cause customers to seek damages for losses incurred, cause customers to seek alternate providers, or make it more difficult for us to attract new customers, retain current customers or enter into additional strategic relationships. Any of these occurrences could result in significant operating losses.

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

NAVISITE, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

confidential information. Several of our Internet 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 such interruptions or breaches, and we expect to expend additional financial resources in the future to equip our data centers with enhanced security measures. 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.

The misappropriation of our proprietary rights could result in the loss of our competitive advantage in the market. We rely on a combination of trademark, service mark, copyright and trade secret laws and contractual restrictions to establish and protect our proprietary rights. We do not own any patents that would prevent or inhibit competitors from using our technology or entering our market. We cannot assure you that the contractual arrangements or other steps taken by us to protect our proprietary rights will prove sufficient to prevent misappropriation of our proprietary rights or to deter independent, third-party development of similar proprietary assets. In addition, we provide our services in other countries where the laws may not afford adequate protection for our proprietary rights.

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 Internet 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 technology to us. We expect that our customers and we increasingly will be subject to third-party infringement claims as the number of Web sites and third-party service providers for Internet-based businesses grows. 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, or require us to enter into royalty or licensing agreements.

We may be subject to legal claims in connection with the information disseminated through our network, which could have the effect of diverting management s attention and requires us to expend significant financial resources. We may face potential direct and indirect liability for claims of defamation, negligence, copyright, patent or trademark infringement, violation of securities laws and other claims based on the nature and content of the materials disseminated through our network. For example, lawsuits may be brought against us claiming that content distributed by some of our current or future 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 complaints against service providers that enable such 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 such 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.

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NAVISITE, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The emergence and growth of a market for our Internet application services will be impaired if third parties do not continue to develop and improve the Internet infrastructure. The recent growth in the use of the Internet has caused frequent periods of performance degradation, requiring the upgrade of routers and switches, telecommunications links and other components forming the infrastructure of the Internet-by-Internet service providers and other organizations with links to the Internet. Any perceived degradation in the performance of the Internet as a means to transact business and communicate could undermine the benefits and market acceptance of our services. Our services are ultimately limited by, and dependent upon, the speed and reliability of hardware, communications services and networks operated by third parties. Consequently, the market for our services will be impaired if improvements are not made to the entire Internet infrastructure to alleviate overloading and congestion.

We must develop and maintain positive brand name awareness. We believe that establishing and maintaining our brand name is essential to expanding our business and attracting new customers. We also believe that the importance of brand name recognition will increase in the future as technology-related companies continue to differentiate themselves. Promotion and enhancement of our brand name will depend largely on our ability to provide consistently high-quality services. If we are unable to provide high-quality services, the value of our brand names will suffer and our business prospects would be adversely affected.

If we fail to attract or retain key officers, key management and technical personnel, then 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 the continued service of key personnel is a key component of the future success of our business. The familiarity of these individuals with the hosting and application management industry in which we operate makes them especially critical to our success. In addition, our success is dependent on our ability to attract, train, retain and motivate high quality personnel. The loss of the services of any of our executive officers or key employees may harm our business, particularly the loss of key members of our sales and marketing teams or key technical service personnel could adversely affect relations with our customers. Our success also depends on our continuing ability to attract, train, retain and motivate other highly qualified technical and managerial personnel. Competition for such personnel is intense. The departure of Arthur P. Becker, as our Chief Executive Officer and President, would have negative ramifications on our customer relations and operations. Any officer or employee can terminate his or her relationship with us at any time. In addition, we do not carry life insurance on any of our key personnel. Any loss of key technical personnel could adversely affect the stability of our infrastructure and our ability to provide the guaranteed service levels our customers expect. Over the past year, we have had significant reductions-in-force and a number of departures of key management. In the event that future reductions or departures of employees occur, our ability to successfully execute our business strategy, or to continue to provide services to our customers, could be adversely affected. Our business requires individuals with significant levels of Internet application expertise to win consumer confidence in outsourcing the hosting and management of mission-critical applications. Qualified technical personnel are likely to remain a limited resource for the foreseeable future. We may not be able to retain or hire the necessary personnel to implement our business strategy or may need to provide higher compensation to such personnel than we currently anticipate.

Our common stockholders have experienced dilution because of conversions of convertible notes by Atlantic Investors and its affiliates and the issuance of new shares of common stock in connection with acquisition of companies or businesses. You may experience additional dilution in the future. On December 12, 2002, CBT and its affiliates converted $20 million of the $65 million of convertible notes obtained from CMGI and Hewlett-Packard Financial Services Company into 5,128,205 shares of our common stock. In February 2003 and September 2003, we issued an aggregate of 410,353 shares of our common stock in connection with our acquisition of Avasta, Inc. On June 17, 2003, CBT and its affiliates converted $41.2 million of the then outstanding $45 million convertible note into 10,559,248 shares of our common stock at a conversion price of $3.90 per share. On August 8, 2003, we issued 1,100,000 shares of our common stock

NAVISITE, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

to CBT in connection with the acquisition of all of the shares of six (6) wholly-owned subsidiaries of CBT and the revenues and expenses of four (4) of its other wholly-owned subsidiaries. Although no convertible promissory notes are presently outstanding, if additional funds are raised through the issuance of additional equity or convertible debt securities or additional securities are issued in connection with future acquisitions and option exercises, our stockholders percentage of ownership will be reduced and they may experience additional dilution.

The unpredictability of our quarterly results may adversely affect the trading price of our common stock. Our quarterly operating results may vary significantly from quarter-to-quarter 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:

- reduction of market demand and/or acceptance from our services;
- oversupply of data center space in the industry;
- our ability to develop, market and introduce new services on a timely basis;
- the length of the sales cycle for our services;
- the timing and size of sales of our services;
- the budgeting cycles of our customers and potential customers;
- downward price adjustments by our competitors;
- changes in the mix of services provided by our competitors;
- technical difficulties or system downtime affecting the Internet generally or our hosting operations specifically;
- our ability to meet any increased technological demands of our customers;
- the amount and timing of costs related to our marketing efforts and service introductions; and
- economic conditions specific to our industry.

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

The price of our common stock has been volatile and our common stock could be delisted from the Nasdaq SmallCap Market. The market price of our common stock has been, and is likely to continue to be, volatile, experiencing wide fluctuations. In recent years, the stock market has experienced significant price and volume fluctuations, which have particularly impacted the market prices of equity securities of many companies providing technology-related products and services. The volatility in the stock market often has been unrelated to the operating performance of particular companies. In the past, securities class action litigation often has been brought against companies that experience volatility in the market price of their securities. Whether or not meritorious, litigation brought against us could result in substantial costs and a diversion of management s attention and resources. The market price of our common stock may also fluctuate substantially due to a variety of other factors, including: public announcements concerning us, our competitors, or our industry; the introduction or market acceptance of new service offerings by us or our competitors; changes in accounting principles; sales of our common stock by existing stockholders; and the loss of any of our key personnel.

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NAVISITE, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Our common stock currently trades on the Nasdaq SmallCap Market. If we fail to meet the Nasdaq SmallCap Market maintenance standards, such as by having the market price of our common stock trade below $1.00 per share for an extended period of time, our common stock could be delisted from Nasdaq. Such delisting would have an adverse effect on our business and our stock price. We could be delisted from the Nasdaq SmallCap Market and may be traded on the over-the-counter electronic bulletin board, which is operated by the National Association of Securities Dealers, Inc. If our common stock is delisted from the Nasdaq SmallCap Market, this could result in a number of negative implications, including continued reduced liquidity in our common stock, as well as the potential loss of confidence by suppliers, customers and employees, fewer business development and acquisition opportunities and greater difficulty in obtaining financing.

We may become subject to burdensome government regulation and legal uncertainties that could substantially impair our business or expose us to unanticipated liabilities. It is likely that laws and regulations directly applicable to the Internet or to Internet 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 Internet 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 such 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 there.

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. In furtherance of our international activities, 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;
- reduced protection of intellectual property rights;
- fluctuations in currency exchange rates;
- ability to secure and maintain the necessary physical and telecommunications infrastructure;
- challenges in staffing and managing foreign operations; and
- employment laws and practices in foreign countries.

Furthermore, some foreign governments have enforced laws and regulations on content distributed over the Internet that are more restrictive than those currently in place in the United States. Any one or more of these factors could adversely affect our contemplated future international operations and consequently, our business.

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NAVISITE, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

Our exposure to market rate risk for changes in interest rates relates primarily to our cash equivalents. From time to time, we invest our excess cash in money market funds. We do not currently have any significant foreign operations and thus are not materially exposed to foreign currency fluctuations.

Item 4. *Controls and Procedures*

Disclosure Controls and Procedures. The Company s management, with the participation of the Company s Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the Company s disclosure controls and procedures (as such term is defined in Rules 13a-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)) as of the end of the period covered by this report. Based on such evaluation, the Company s Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of such period, the Company s disclosure controls and procedures are effective in recording, processing, summarizing and reporting, on a timely basis, information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act.

Internal Control Over Financial Reporting. There have not been any changes in the Company s internal control over financial reporting (as such term is defined in Rules 13a-15(f) under the Exchange Act) during the fiscal quarter to which this report relates that have materially affected, or are reasonably likely to materially affect, the Company s internal control over financial reporting.

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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 revenues. 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.

We believe that the allegations against us are without merit and we intend to vigorously defend against the plaintiffs claims. We are not able to predict the possible outcome of the suits and their ultimate effect, if any, on our financial condition.

Goldman Sachs Payment Demand

In March 2001, we engaged Goldman Sachs & Co. to serve as our financial advisor in connection with the possible sale of all or a portion of NaviSite. On September 17, 2002, Goldman made a written demand for payment of a $3 million success fee in connection with the September 2002 acquisition by CBT of the stock and convertible debt of NaviSite from CMGI and Hewlett-Packard Financial Services Company. We have rejected Goldman s demands, as we believe they are without merit. No legal actions have been filed concerning the Goldman claim. As this matter is in the initial stage, we are not able to predict the possible outcome of this matter and the effect, if any, on our financial condition.

Joseph Cloonan

On or about September 27, 2002, we received a demand for a wage payment of $850,000 from our former Procurement Director, Joseph Cloonan. We rejected the demand, alleging that Mr. Cloonan s claim is based, among other things, on a potentially fraudulent contract. Mr. Cloonan also claimed $40,300 for allegedly unpaid accrued vacation and bonuses and that he may be statutorily entitled to treble damages and legal fees. On October 11, 2002, NaviSite filed a civil complaint with the Massachusetts Superior Court, Essex County, seeking a declaratory judgment and asserting claims against Mr. Cloonan for civil fraud, misrepresentation, unjust enrichment and breach of duty of loyalty. Mr. Cloonan asserted counter claims against NaviSite seeking the payments set forth in his September 2002 demand. We believe Mr. Cloonan s allegations are without merit and intend to vigorously defend against them. As the litigation is in the initial discovery stage, we are not able to predict the possible outcome of this matter and the effect, if any, on our financial condition.

Lighthouse International

On October 28, 2002, CBTM, one of our subsidiaries, filed a complaint in United States District Court for the Southern District of New York against Lighthouse International, alleging six causes of action for copyright infringement, breach of contract, account stated, unjust enrichment, unfair competition, and misappropriation and/or conversion. The total claimed damages are in the amount of $1,866,450. On or about January 16, 2003, Lighthouse filed and served its answer and counterclaimed against CBTM claiming $3,130,000 in damages and $5,000,000 in punitive relief.

On June 17, 2003, the U.S. Bankruptcy Court for the Southern District of New York heard oral argument on Lighthouse s Motion for an Order Compelling the Debtor (AppliedTheory) to Assume or Reject an Agreement, filed in response to CBTM s. complaint, and the objections to Lighthouse s motion filed by

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CBTM and AppliedTheory. Lighthouse made this motion on the basis that it never received notice of CBTM assuming the AppliedTheory contract for the LighthouseLink Web site. The Bankruptcy Court declined to grant Lighthouse s motion, and instead ordered that an evidentiary hearing be conducted to determine whether Lighthouse received appropriate notice of the proposed assignment of the contract by AppliedTheory to CBTM. The Bankruptcy Court ordered that the parties first conduct discovery, and upon completion of discovery, which is expected to be completed on or about the end of January 2004, the Bankruptcy Court would schedule an evidentiary hearing on the issue of notice.

A number of discovery disputes existing between the parties were resolved by Magistrate Judge Theodore Katz at the October, 2003 pre-trial conference, including the lifting of a stay on the completion of depositions. As discovery proceeds, and additional materials and information are obtained not only from Lighthouse, but also from a number of third parties, we anticipate that depositions will commence during the latter part of December and continue during the month of January. Discovery also continues simultaneously in the bankruptcy proceeding. Because of the continuing discovery processes, we are not able to predict the possible outcome of these matters, if any, on our financial condition.

Avasta Earnout

On October 14, 2003, we received a letter purportedly on behalf of the former stockholders of Avasta relating to the issuance of additional shares of common stock pursuant to the earnout calculations pursuant to the Agreement and Plan of Merger and Reorganization dated as of January 29, 2003 among Avasta Corp., Avasta, Inc. and NaviSite. On December 11, 2003, a demand for arbitration before JAMS was filed claiming among other things breach of contract, tortious conduct, fraud and other wrongful conduct. Damages sought include in excess of 691,538 shares of NaviSite common stock. As this matter is in the initial stage, we are not able to predict the possible outcome of this matter and the effect, if any, on our financial condition.

La Jolla Landlord

On November 24, 2003, U.S. Property Fund GmbH & Co, the landlord for space leased by NaviSite in La Jolla, California, filed a breach of lease action against NaviSite. The landlord claims damages in excess of $2,000,000. As this matter is in the initial stage, we are not able to predict the possible outcome of this matter and the effect, if any, on our financial condition.

Item 6. ***Exhibits and Reports on Form 8-K***

(a) *Exhibits*

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

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(b) *Reports on Form 8-K*

Date Filed or Furnished	Item No.	Description
October 22, 2003	Items 5, 7	On October 22, 2003, the Company filed Amendment No. 1 to Current Report on Form 8-K/ A to amend the Company s Current Report on Form 8-K dated August 8, 2003 to report under Item 5 (Other Events) additional information about ClearBlue Technologies, Inc. The following financial statements were filed with such report:
		Combined financial statements for the Carve-out Businesses of ClearBlue Technologies, Inc. as of July 31, 2003 and 2002 and for the year ended July 31, 2003 and for the ten-months ended July 31, 2002 (audited)
		Pro forma Condensed Consolidated Balance Sheet of NaviSite, Inc. as of July 31, 2003 and Condensed Consolidated Statement of Operations for the year ended July 31, 2003 (unaudited)
October 27, 2003*	Item 12	On October 27, 2003, the Company furnished a copy of the Company s earnings release for its fiscal fourth quarter and fiscal year ended July 31, 2003. No financial statements were furnished with such report.

* This furnished Form 8-K is not to be deemed filed or incorporated by reference into any filing.

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SIGNATURE

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

NAVISITE, INC.

By: /s/ JAMES W. PLUNTZE

James W. Pluntze
Chief Financial Officer (Principal Financial and Accounting Officer)

Date: December 15, 2003

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EXHIBIT INDEX

Item	Description
10.1	Amendment No. 1 to Lease, by and between 400 River Limited Partnership and the Registrant.
10.2	Amendment No. 6 to Professional Services Agreement, dated as of September 24, 2003, by and between the New York State Department of Labor and ClearBlue Technologies Management, Inc. (as assignee of AppliedTheory Corporation).
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.