NAVISITE INC
Form 10-Q
June 23, 2008

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 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 April 30, 2008

OR

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

For the transition period from __________ to __________

Commission file number: 000-27597

NAVISITE, INC.

(Exact name of registrant as specified in its charter)

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

(978) 682-8300

(Registrant s telephone number, including area code)

None

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

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

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

Large accelerated filer o	Accelerated filer o	Non-accelerated filer þ	Smaller reporting company o

(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No þ

As of June 6, 2008, there were 35,079,985 shares outstanding of the registrant s common stock, par value $.01 per share.

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REPORT ON FORM 10-Q
FOR THE QUARTER ENDED APRIL 30, 2008

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PART I: FINANCIAL INFORMATION

Item 1. Financial Statements

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

	April 30, 2008	July 31, 2007
ASSETS		
Current assets:		
Cash and cash equivalents	$ 4,938	$ 11,701
Accounts receivable, less allowance for doubtful accounts of $713 and $781 at April 30, 2008 and July 31, 2007, respectively	20,050	15,051
Unbilled accounts receivable	2,018	920
Prepaid expenses and other current assets	15,583	15,975
Total current assets	42,589	43,647
Property and equipment, net	37,950	15,841
Intangible assets	33,012	7,755
Goodwill	64,712	43,159
Other assets	3,883	4,158
Restricted cash	1,837	1,684
Total assets	$ 183,983	$ 116,244
LIABILITIES AND STOCKHOLDERS EQUITY (DEFICIT)		
Current liabilities:		
Notes payable, current portion	7,233	1,063
Notes payable to the AppliedTheory Estate	6,000	6,000
Capital lease obligations, current portion	3,009	1,829
Accounts payable	7,376	3,913
Accrued expenses and other current liabilities	14,936	15,494
Deferred revenue, deferred other income and customer deposits	4,045	4,737
Total current liabilities	42,599	33,036
Capital lease obligations, less current portion	15,283	1,030
Accrued lease abandonment costs, less current portion	579	645
Deferred tax liability	5,097	3,685
Other long-term liabilities	4,593	2,612
Note payable, less current portion	108,125	89,100
Total liabilities	176,276	130,108
Series A Convertible Preferred Stock, $0.01 par value; Authorized 5,000 shares; issued and outstanding: 3,255 at April 30, 2008; 0 shares at July 31, 2007	26,750	

Commitments and contingencies (Note 12)		
Stockholders equity (deficit):		
Common stock, $0.01 par value; Authorized 395,000 shares; Issued and outstanding: 35,052 at April 30, 2008 and 33,506 at July 31, 2007	350	335
Accumulated other comprehensive income	321	381
Additional paid-in capital	484,291	481,199
Accumulated deficit	(504,005)	(495,779)
Total stockholders equity (deficit)	7,707	(13,864)
Total liabilities and stockholders equity (deficit)	$ 183,983	$ 116,244

See accompanying notes to condensed consolidated financial statements.

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

	Three Months Ended		Nine Months Ended	
	April 30, 2008	April 30, 2007	April 30, 2008	April 30, 2007
Revenue, net	$39,249	$32,664	$114,112	$91,225
Revenue, related parties	73	84	220	260
Total revenue, net	39,322	32,748	114,332	91,485
Cost of revenue, excluding depreciation and amortization	21,767	18,710	64,360	52,304
Depreciation and amortization	5,526	3,204	14,928	9,399
Cost of revenue	27,293	21,914	79,288	61,703
Gross profit	12,029	10,834	35,044	29,782
Operating expenses:				
Selling and marketing	4,538	4,274	14,814	12,129
General and administrative	5,530	5,508	16,650	16,662
Impairment, restructuring and other				(287)
Total operating expenses	10,068	9,782	31,464	28,504
Income from operations	1,961	1,052	3,580	1,278
Other income (expense):				
Interest income	38	79	214	163
Interest expense	(3,179)	(3,307)	(8,845)	(9,735)
Loss on debt extinguishment			(1,651)	
Other income (expense), net	70	110	547	356
Loss from continuing operations before income taxes and discontinued operations	(1,110)	(2,066)	(6,155)	(7,938)
Income taxes	(501)	(293)	(1,414)	(880)
Loss from continuing operations before discontinued operations	(1,611)	(2,359)	(7,569)	(8,818)
Loss from discontinued operations, net of income taxes	(106)		(657)	

Net loss	(1,717)	(2,359)	(8,226)	(8,818)
Accretion of preferred stock dividends	(757)		(1,877)	
Net loss attributable to common stockholders	(2,474)	(2,359)	(10,103)	(8,818)
Basic and diluted net loss per common share:				
Loss from continuing operations before discontinued operations attributable to common stockholders	$ (0.07)	$ (0.08)	$ (0.27)	$ (0.29)
Loss from discontinued operations, net of income taxes			(0.02)	
Net loss attributable to common stockholders	$ (0.07)	$ (0.08)	$ (0.29)	$ (0.29)
Basic and diluted weighted average number of common shares outstanding	35,033	31,128	34,605	29,947

See accompanying notes to condensed consolidated financial statements.

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

	Nine Months Ended	
	April 30, 2008	**April 30, 2007**
Cash flows from operating activities of continuing operations:		
Net loss	$ (8,226)	$ (8,818)
Loss from discontinued operations	657	
Loss from continuing operations before discontinued operations	(7,569)	(8,818)
Adjustments to reconcile net loss to net cash provided by (used for) operating activities of continuing operations:		
Depreciation and amortization	15,558	10,285
Mark to market for interest rate cap	119	164
Costs (recoveries) associated with abandoned leases		(287)
Amortization of warrants		1,642
Gain on disposal of assets	(1)	
Stock based compensation	3,227	2,686
Provision for bad debts	308	
Deferred income tax expense	1,414	880
Loss on debt extinguishment	1,651	
Changes in operating assets and liabilities:		
Accounts receivable	(1,165)	(3,865)
Unbilled accounts receivable	(1,072)	(665)
Due from related party		30
Prepaid expenses and other current assets, net	(6,958)	(509)
Long term assets	39	583
Accounts payable	2,558	(1,020)
Long-term liabilities	120	2,636
Accrued expenses, deferred revenue and customer deposits	(5,525)	(574)
Net cash provided by operating activities of continuing operations	2,704	3,168
Cash flows from investing activities of continuing operations:		
Purchase of property and equipment	(8,783)	(5,107)
Cash used for acquisitions, net of cash acquired	(31,364)	
Releases of (transfers to) restricted cash	8,563	(2)
Proceeds from the sale of assets	1	
Net cash used for investing activities of continuing operations	(31,583)	(5,109)
Cash flows from financing activities of continuing operations:		
Proceeds from exercise of stock options and warrants	1,532	1,929
Proceeds from notes payable	28,881	5,517
Repayment of notes payable	(3,686)	(2,411)

Debt issuance costs	(1,112)	
Payments on capital lease obligations	(2,842)	(1,830)
Net cash provided by financing activities of continuing operations	22,773	3,205
Cash used for operating activities of discontinued operations	(657)	
Net (decrease) increase in cash and cash equivalents	(6,763)	1,264
Cash and cash equivalents, beginning of period	11,701	3,360
Cash and cash equivalents, end of period	$ 4,938	$ 4,624

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	Nine Months Ended April 30, 2008	Nine Months Ended April 30, 2007
Supplemental disclosure of cash flow information:		
Cash paid for interest	$ 8,293	$6,617
Equipment and leasehold improvements acquired under capital leases	$16,950	$1,932

See accompanying notes to condensed consolidated financial statements.

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

(1) Description of Business

NaviSite, Inc. (NaviSite , the Company , we , us or our) provides application management, managed hosting solutions and professional services for mid-market organizations. Leveraging our set of technologies and subject matter expertise, we deliver cost-effective, flexible solutions that provide responsive and predictable levels of service for our customers businesses. Over 1,400 companies across a variety of industries rely on NaviSite to build, implement and manage their mission-critical systems and applications. NaviSite is a trusted advisor committed to ensuring the long-term success of our customers business applications and technology strategies. At April 30, 2008, NaviSite had 17 state-of-the-art data centers in the U.S. and U.K. and a network operations center in India. Substantially all revenue is generated from customers in the U.S.

(2) Summary of Significant Accounting Policies

(a) Basis of Presentation and Principles of Consolidation

The accompanying unaudited condensed consolidated financial statements include the accounts and operations of the Company and its wholly-owned subsidiaries and have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission regarding interim financial reporting. Accordingly, they do not include all of the information and notes required by U.S. generally accepted accounting principles for complete financial statements and thus should be read in conjunction with the audited consolidated financial statements included in our Annual Report on Form 10-K filed on November 9, 2007. In the opinion of management, the accompanying unaudited condensed consolidated financial statements contain all adjustments, consisting only of those of a normal recurring nature, necessary for a fair presentation of the Company s financial position, results of operations and cash flows at the dates and for the periods indicated. The results of operations for the three and nine months ended April 30, 2008 are not necessarily indicative of the results expected for the remainder of the fiscal year ending July 31, 2008.

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

(b) Use of Estimates

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

(c) Revenue Recognition

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

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

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

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

(d) Cash and Cash Equivalents and Restricted Cash

The Company considers all highly liquid securities with original maturities of three months or less to be cash equivalents. The Company had restricted cash of $6.8 million and $15.4 million as of April 30, 2008 and July 31, 2007, respectively, including $5.0 million and $13.7 million as of April 30, 2008 and July 31, 2007, respectively, that is classified as short-term in the Condensed Consolidated Balance Sheets and is included in Prepaid expenses and other current assets . Restricted cash at April 30, 2008 represents cash held in escrow related to our note payable to the AppliedTheory Estate (see Note 10(e)) and cash collateral requirements for standby letters of credit associated with several of the Company s facility and equipment leases.

(e) Property and Equipment

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

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

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

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

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

by the amount by which the carrying amount of the assets exceeds the fair value of the assets. Assets to be disposed of are reported at the lower of the carrying amount or fair value less cost to sell.

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

(g) Concentration of Credit Risk

Our financial instruments include cash, accounts receivable, obligations under capital leases, debt agreements, derivative instruments, preferred stock, accounts payable, and accrued expenses. As of April 30, 2008, the carrying cost of these instruments approximated their fair value. The financial instruments that potentially subject us to concentrations of credit risk consist primarily of accounts receivable. Concentrations of credit risk with respect to trade receivables are limited due to the large number of customers across many industries that comprise our customer base.

(h) Comprehensive Income

Comprehensive income is defined as the change in equity of a business enterprise during a period of time from transactions and other events and circumstances from non-owner sources. The Company records the components of comprehensive income, primarily foreign currency translation adjustments, in the Condensed Consolidated Balance Sheets as a component of Stockholders Equity (Deficit), Accumulated other comprehensive income. For the three and nine months ended April 30, 2008, comprehensive loss totaled approximately $1.8 million and $8.3 million, respectively. For the three and nine months ended April 30, 2007, comprehensive loss totaled approximately $2.3 million and $8.7 million, respectively.

(i) Income Taxes

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

(j) Stock Based Compensation

Stock Options

The Company maintains four stock incentive plans under which employees and outside directors have been granted nonqualified stock options to purchase the Company s common stock. Only one plan, the NaviSite 2003 Stock Incentive Plan (2003 Plan), is currently available for new equity award grants. For the Company s employees, options granted are generally exercisable as to 25% of the original number of shares on the sixth month (180^{th} day) anniversary of the option holder s grant date and, thereafter, in equal amounts monthly over the three year period commencing on the sixth month (180^{th} day) anniversary of the option holder s grant date. Options granted under the 2003 Plan have a maximum term of ten years.

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(Unaudited)

The Company s current practice is to grant all options with an exercise price equal to the fair market value of the Company s common stock on the date of grant. The Company issued stock options for the purchase of approximately 0.3 million and 1.7 million shares of common stock during the three and nine months ended April 30, 2008, respectively, at a weighted average exercise price per share of $3.26 and $6.63, respectively. During the three and nine months ended April 30, 2007, the Company issued stock options for the purchase of approximately 0.8 million and 2.0 million shares, respectively, of common stock at a weighted average exercise price of $5.90 and $4.85 per share, respectively.

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

	Three Months Ended April 30,		Nine Months Ended April 30,	
	2008	2007	2008	2007
Expected life (years)	2.5	2.5	2.5	3.10
Expected volatility	79.36%	93.88%	83.07%	101.04%
Expected dividend rate	0.00%	0.00%	0.00%	0.00%
Risk-free interest rate	2.17%	4.57%	3.49%	4.58%

Stock compensation expense related to stock options recognized in the condensed consolidated statements of operations is as follows:

	Three Months Ended April 30, (in thousands)		Nine Months Ended April 30, (in thousands)	
	2008	2007	2008	2007
Cost of revenue	$ 189	$ 364	$ 1,381	$ 887
Selling and marketing	115	171	543	372
General and administrative	138	317	771	1,427
Total	$ 442	$ 852	$ 2,695	$ 2,686

Non-vested Shares

During the nine months ended April 30, 2008, the Company granted approximately 0.2 million non-vested shares of common stock to certain executives under the 2003 Plan, at a weighted average grant date fair value of $7.93 per share. These non-vested shares carry restrictions which lapse as the employees provide service as to one-third of the shares per annum on each of the first, second, and third anniversaries of the date of grant. With respect to 0.1 million of the non-vested shares, the restrictions may lapse on earlier date as to 100% of the shares if the Company achieves certain revenue and EBITDA targets for its 2008 fiscal year. The grant date fair value of the non-vested shares was determined based on the market price of the Company s common stock on the date of grant.

In December 2007, the Company granted approximately 63,000 non-vested shares to certain members of the Company s Board of Directors under the 2003 Plan, at a weighted average grant date fair value of $5.50 per share. These non-vested shares carry restrictions as to resale which lapse with time over the twelve month period beginning with the date of grant. The grant date fair value of the non-vested shares was determined based on the market price of the Company s common stock on the date of grant.

NAVISITE, INC.
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Compensation expense related to non-vested shares is recognized ratably over the expected requisite service period related to the non-vested shares. During the three and nine months ended April 30, 2008, approximately $201 thousand and $457 thousand of compensation expense was recognized in general and administrative expense in the accompanying condensed consolidated statement of operations related to these non-vested shares. For accounting purposes, the non-vested shares are excluded from our issued and outstanding share amounts presented in our condensed consolidated balance sheet at April 30, 2008.

Employee Stock Purchase Plan

NaviSite s 1999 Employee Stock Purchase Plan (the ESPP) was adopted by the Board of Directors and approved by the stockholders in October 1999. A total of 6,666 shares of the Company s common stock, as adjusted, were originally reserved for issuance, thereunder. An amendment to increase the number of shares reserved for issuance under the ESPP to 16,666 shares, as adjusted, was adopted by the Board of Directors on October 1, 2000 and approved by the stockholders on December 20, 2000. As of September 30, 2007, 16,657 of the shares reserved for issuance under the ESPP had been issued.

On November 8, 2007, the Board of Directors approved an amendment and restatement of the ESPP to increase the number of shares reserved for issuance under the ESPP from 16,666 shares, as adjusted, to 516,666 shares. This was approved by the stockholders on December 12, 2007.

Under the ESPP, employees who elect to participate instruct the Company to withhold a specified amount through payroll deductions during the offering period of six months. On the last business day of each offering period, the amount withheld is used to purchase the Company s common stock at an exercise price equal to 85% of the lower of the market price on the first or last business day of the offering period. During the nine months ended April 30, 2008, the Company did not issue any shares under the ESPP.

Compensation expense for the ESPP is recognized over the offering period. During the three and nine months ended April 30, 2008, approximately $38 thousand of compensation expense was recognized in cost of sales, $20 thousand of compensation was recognized in sales and marketing, and $17 thousand of compensation was recognized in general and administrative expense in the accompanying condensed consolidated statement of operations.

(k) Net Loss Per Share

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

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

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

	Three Months Ended April 30, 2008	Three Months Ended April 30, 2007	Nine Months Ended April 30, 2008	Nine Months Ended April 30, 2007
Common stock options	1,280,363	2,653,538	2,258,111	2,047,511
Common stock warrants	1,196,700	2,297,404	1,201,832	1,849,749
Non-vested stock			158,339	
Series A Convertible Preferred Stock	3,290,646		3,290,646	
Employee Stock Purchase Plan			19,212	
Total	5,767,709	4,950,942	6,928,140	3,897,260

(l) Segment Reporting

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

(m) Foreign Currency

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

(n) Derivative Financial Instruments

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

(3) Reclassifications

Certain fiscal year 2007 amounts have been reclassified to conform to the current year presentation.

(4) Acquisitions

(a) Acquisition of Jupiter Hosting, Inc.

On August 10, 2007, the Company acquired the outstanding capital stock of Jupiter Hosting, Inc. (Jupiter), a privately held company based in Santa Clara, CA that provides managed hosting services that typically involve high bandwidth applications, for total consideration of $8.8 million in cash. In connection with the acquisition of Jupiter, the Company entered into an escrow arrangement whereby $0.7 million was placed in escrow through May 2008, and represents value necessary to settle any breach of representations or warranties by either of the Company or the former owners of Jupiter. The initial escrow is included as a component of the total consideration of $8.8 million. The historical operating results of Jupiter s operations have been included in the condensed consolidated financial statements since the date of acquisition. Of the total consideration of $8.8 million, $8.7 million was initial consideration paid to the former shareholders of Jupiter and $0.1 million represents direct costs related to the closing

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

of the acquisition.

The following table summarizes the estimated fair value of the assets acquired and liabilities assumed at the date of the acquisition. The Company is in the process of finalizing its purchase price allocation; thus the allocation of the purchase price is preliminary and is subject to refinement and finalization based on the results of the valuation of the intangible assets acquired.

		August 10, 2007 (In thousands)
Current assets	$	1,178