TERAGO INC.
Condensed Consolidated Financial Statements
Three months ended March 31, 2014 and 2013
(unaudited)

Contents

TERAGO INC.
Consolidated Statements of Financial Position
(In thousands)

	March 31 2014	December 31 2013
Assets		
Cash and cash equivalents	$ 878	$ 2,137
Short-term investments (Note 4)	73	452
Accounts receivable (Note 4)	2,945	2,933
Prepaid expenses	3,006	2,382
Total current assets	6,902	7,904
Network assets, property and equipment (Note 5)	42,465	41,042
Intangible assets (Note 6)	11,790	12,183
Deferred income taxes	2,700	2,700
Restricted cash (Note 7)	821	821
Goodwill	5,908	5,908
Total non-current assets	63,684	62,654
Total Assets	$ 70,586	$ 70,558
Liabilities		
Accounts payable and accrued liabilities	$ 7,946	$ 6,008
Current portion of deferred revenue	601	561
Current portion of long-term debt (Note 8)	6,357	6,288
Current portion of other long-term liabilities (Note 9)	18	237
Total current liabilities	14,922	13,094
Decommissioning and restoration obligations	213	210
Deferred revenue	94	277
Long-term debt (Note 8)	11,854	12,824
Other long-term liabilities (Note 9)	602	627
Total non-current liabilities	12,763	13,938
Total Liabilities	27,685	27,032
Shareholders' Equity		
Share capital	71,835	71,461
Contributed surplus	24,251	24,157
Deficit	(53,185)	(52,092)
Total shareholders' equity	42,901	43,526
Total Liabilities and Shareholders' Equity	$ 70,586	$ 70,558

Subsequent Events (Notes 7 and 14)

On behalf of the Board:

"Charles Allen"
Director

"Grant Ballantyne"
Director

The accompanying notes are an integral part of these financial statements.

TERAGO INC.
Consolidated Statements of Comprehensive Earnings
(In thousands, except per share amounts)

	Three months ended March 31 2014	Three months ended March 31 2013
Revenue		
Service	$ 12,708	$ 12,293
Installation	166	277
	12,874	12,570
Expenses		
Direct cost of services	2,517	2,391
Salaries and related costs - Cost of services	357	379
Salaries and related costs - Other	5,333	3,997
Other operating expenses	2,139	1,418
Amortization of intangible assets (Note 6)	712	516
Depreciation of network assets, property and equipment (Note 5)	2,576	2,330
	13,634	11,031
Earnings (loss) from operations	(760)	1,539
Foreign exchange gain (loss)	(33)	(19)
Finance costs	(319)	(188)
Finance income	19	8
Net earnings (loss) and comprehensive earnings (loss)	$ (1,093)	$ 1,340
Deficit, beginning of period	(52,092)	(56,401)
Deficit, end of period	$ (53,185)	$ (55,061)
Basic earnings (loss) per share (Note 11)	$ (0.10)	$ 0.12
Diluted earnings (loss) per share (Note 11)	$ (0.10)	$ 0.11
Basic weighted average number of shares outstanding	11,490	11,397
Diluted weighted average number of shares outstanding	11,490	11,960

The accompanying notes are an integral part of these financial statements.

TERAGO INC.
Consolidated Statements of Cash Flows
(In thousands)

	Three months ended March 31 2014	Three months ended March 31 2013
Cash provided by (used in)		
Operating Activities		
Net earnings (loss)	$ (1,093)	$ 1,340
Adjustments to reconcile net earnings to net cash provided by (used in) operating activities:		
Depreciation of network assets, property and equipment (Note 5)	2,576	2,330
Amortization of intangible assets (Note 6)	712	516
Stock-based compensation expense (recovery) (Note 10)	751	(13)
Finance costs	319	188
Finance income	(19)	(8)
Loss (gain) on adjustments and disposal of network assets (Note 5)	12	(39)
Changes in non-cash working capital items:		
Accounts receivable	(12)	78
Prepaid expenses	(624)	(491)
Accounts payable and accrued liabilities	172	(1,015)
Deferred revenue	(143)	(241)
Other long-term liabilities	(201)	-
Cash from Operating Activities	2,450	2,645
Investing Activities		
Proceeds from disposal of network assets	-	1
Purchase of network assets, property and equipment (Note 5)	(4,011)	(2,106)
Purchase of intangible assets (Note 6)	(319)	(337)
Change in non-cash working capital related to network assets, property and equipment, and intangible assets	1,137	77
Purchase of short-term investments	(274)	(1,394)
Sale of short-term investments	664	385
Cash used in Investing Activities	(2,803)	(3,374)
Financing Activities		
Proceeds from issuance of share capital	304	188
Interest paid	(316)	(159)
Interest received	8	8
Proceeds from long-term debt (Note 8)	557	1,000
Repayment of long-term debt	(1,458)	(714)
Repayment of finance lease obligations	(1)	(43)
Cash from (used in) Financing Activities	(906)	280
Net change in cash and cash equivalents, during the period	(1,259)	(449)
Cash and cash equivalents, beginning of period	2,137	1,469
Cash and cash equivalents, end of period	$ 878	$ 1,020

The accompanying notes are an integral part of these financial statements.

TERAGO INC.
Consolidated Statements of Changes in Equity
(In thousands)

	Share Capital Number	Share Capital Amount	Contributed Surplus	Deficit	Total
Balance, December 31, 2013	11,459	$ 71,461	$ 24,157	$ (52,092)	$ 43,526
Issuance of shares upon exercise of options	84	322	(18)	-	304
Stock-based compensation	-	-	112	-	112
Issuance of shares for Directors' Fees	10	52	-	-	52
Net loss and comprehensive loss	-	-	-	(1,093)	(1,093)
Balance, March 31, 2014	11,553	$ 71,835	$ 24,251	$ (53,185)	$ 42,901

	Share Capital Number	Share Capital Amount	Contributed Surplus	Deficit	Total
Balance, December 31, 2012	11,365	$ 70,978	$ 24,176	$ (56,401)	$ 38,753
Issuance of shares upon exercise of options	47	188	-	-	188
Issuance of shares for Directors' Fees	5	45	-	-	45
Net earnings and comprehensive earnings	-	-	-	1,340	1,340
Balance, March 31, 2013	11,417	$ 71,211	$ 24,176	$ (55,061)	$ 40,326

The accompanying notes are an integral part of these financial statements.

1. Reporting Entity

TeraGo Inc. (the “Company)” is a leading broadband communications and data centre service provider to businesses in Canada. The Company is located in Canada and the address of its registered office is Suite 500 – 55 Commerce Valley Drive West, Thornhill, Ontario. The Company was incorporated under the Canada Business Corporations Act on December 21, 2000 and owns and operates a carrier-grade, fixed wireless, fibre-based, IP communications network and data centre facilities in Canada targeting small to medium-sized businesses that require broadband Internet, data connectivity, voice and data centre services. The Company’s common shares are listed on the Toronto Stock Exchange (TSX) under the symbol TGO.

2. Basis of Preparation and Presentation

(a) Basis of preparation

These unaudited condensed interim consolidated financial statements (“interim financial statements”) were prepared using the same accounting policies and methods as those used in the Company’s consolidated financial statements for the year ended December 31, 2013 (the “2013 Consolidated Financial Statements”), with the exception of those new accounting pronouncements that were adopted on January 1, 2014 as more fully described in note 3. These interim financial statements are in compliance with International Accounting Standard 34, Interim Financial Reporting (“IAS 34”). Accordingly, certain information and footnote disclosure normally included in annual financial statements prepared in accordance with International Financial Reporting Standards (“IFRS”), as issued by the International Accounting Standards Board ("IASB"), have been omitted or condensed.

The preparation of financial statements in accordance with IAS 34 requires the use of certain critical accounting estimates. It also requires management to exercise judgment in applying the Company’s accounting policies. The areas involving a higher degree of judgment or complexity, or areas where assumptions and estimates are significant to the financial statements have been set out in note 2 of the Company’s 2013 Consolidated Financial Statements. These interim financial statements should be read in conjunction with the Company’s 2013 Consolidated Financial Statements.

The Company's operating results are subject to seasonal fluctuations that may materially impact quarter-to-quarter operating results and, thus, one quarter's operating results are not necessarily indicative of a subsequent quarter's operating results.

The policies applied in these interim financial statements are based on IFRS issued and outstanding as at March 31, 2014. The Board of Directors authorized the interim financial statements for issue on May 7, 2014.

(b) Basis of presentation

These interim financial statements include the accounts of TeraGo Inc. and its wholly-owned subsidiaries, TeraGo Networks Inc. and 2000682 Ontario Inc. (collectively, the Company). The notes presented in these interim financial statements include only significant changes and transactions that have occurred since the last fiscal year end.

(c) Functional and Presentation Currency

These consolidated financial statements are presented in Canadian dollars, which is the Company’s functional currency.

3. Significant Accounting Policies

These interim financial statements were prepared using the same accounting policies and methods as those used in the 2013 Consolidated Financial Statements, except for the adoption of new accounting policies as at January 1, 2014 that are described below:

(a) Levies

In May 2013, the IASB issued IFRIC 21, Levies, which provides guidance on when to recognize a liability for a levy imposed by a government, both for levies that are accounted for in accordance with IAS 37, Provisions, Contingent Liabilities and Contingent Assets and those where the timing and amount of the levy is certain. The Interpretation identifies the obligating event for the recognition of a liability as the activity that triggers the payment of the levy in accordance with the relevant legislation. It provides the following guidance on recognition of a liability to pay levies:

- The liability is recognized progressively if the obligating event occurs over a period of time
- If an obligation is triggered on reaching a minimum threshold, the liability is recognized when that minimum threshold is reached.

(In thousands, except for per share amounts)

The Company has assessed the impact of this standard and determined there is no impact on its consolidated financial statements.

4. Current Assets

Details of selected current asset balances are as follows:

(i) Cash and cash equivalents

The Company's cash and cash equivalents are comprised of bank balances at major Canadian financial institutions.

(ii) Short-term investments

The Company's short-term investments are as follows:

	March 31 2014	December 31 2013
Guaranteed Investment Certificates (maturity dates within 1 year of the statement of financial position with interest rates of 1.25%)	$ 73	$ 452

Interest earned on short-term investments is included in finance income.

(iii) Accounts receivable

The Company's accounts receivable is comprised of the following:

	March 31 2014	December 31 2013
Trade receivables	$ 2,709	$ 2,732
Allowance for doubtful accounts	(13)	(14)
Indemnification receivable	160	160
Other	89	55
	$ 2,945	$ 2,933

5. Network Assets, Property and Equipment

Cost	Network assets	Datacentre infrastructure	Computer equipment	Office furniture and equipment	Leasehold improvements	Vehicles	Total
Balance, December 31, 2013	$ 101,441	$ 1,574	$ 2,028	$ 2,117	$ 663	$ 49	$ 107,872
Additions/ reclassifications	3,997	8	6	-	-	-	4,011
Disposals/ Adjustments	(102)	11	-	-	-	-	(91)
Balance, March 31, 2014	**$ 105,336**	**$ 1,593**	**$ 2,034**	**$ 2,117**	**$ 663**	**$ 49**	**$ 111,792**
Accumulated Depreciation							
Balance, December 31, 2013	$ 62,284	$ 42	$ 1,806	$ 2,053	$ 599	$ 46	$ 66,830
Depreciation for the period	2,487	34	39	9	6	1	2,576
Disposals/ Adjustments	(81)	2	-	-	-	-	(79)
Balance, March 31, 2014	**$ 64,690**	**$ 78**	**$ 1,845**	**$ 2,062**	**$ 605**	**$ 47**	**$ 69,327**
Net Book Value, March 31, 2014	**$ 40,646**	**$ 1,515**	**$ 189**	**$ 55**	**$ 58**	**$ 2**	**$ 42,465**

(In thousands, except for per share amounts)

6. Intangibles Assets

Cost	Radio spectrum licenses	Computer Software	Customer relationships	Other	Total
Balance, December 31, 2013	$ 7,041	$ 6,917	$ 6,180	$ 1,856	$ 21,994
Additions	-	319	-	-	319
Balance, March 31, 2014	**$ 7,041**	**$ 7,236**	**$ 6,180**	**$ 1,856**	**$ 22,313**
Accumulated Amortization					
Balance, December 31, 2013	$ 2,371	$ 4,981	$ 2,057	$ 402	$ 9,811
Amortization for the period	-	311	309	92	712
Balance, March 31, 2014	**$ 2,371**	**$ 5,292**	**$ 2,366**	**$ 494**	**$ 10,523**
Net Book Value, March 31, 2014	**$ 4,670**	**$ 1,944**	**$ 3,814**	**$ 1,362**	**$ 11,790**

7. Restricted Cash

The restricted cash is segregated for the period of a tax indemnity to a former officer in connection with the Company's initial public offering on June 18, 2007, and is invested in a guaranteed investment certificate. The related accrued interest is included in short-term investments. The indemnity is described in note 9 of the 2013 Consolidated Financial Statements and the indemnity period expires in June, 2015. Subsequent to March 31, 2014, the Company received a notice of a claim against the tax indemnity from the former officer relating to the sale of 189 Common Shares. The Company estimated the cost of the indemnity to be paid from the $821 maximum allocated to the former officer and recorded stock-based compensation expense of $630 related to this claim during the three months ended March 31, 2014. The offsetting liability is included in Accounts payable and accrued liabilities.

8. Long-term Debt

	March 31 2014	December 31 2013
Long-term debt facility (i)	$ 17,608	$ 18,454
Equipment loans (ii)	947	1,061
less: financing fees	(344)	(403)
	18,211	19,112
less: current portion	(6,357)	(6,288)
	$ 11,854	$ 12,824

(i) Long-term Debt Facility

The Company entered into an agreement in May 2011 with the Royal Bank of Canada ("RBC") that provides credit facilities totaling $19,000, which was amended in May 2012 to $20,000. In April 2013, the Company entered into an agreement with RBC that provides additional credit facilities of $27,000 on terms substantially consistent with the existing credit facilities. When the agreement was amended in April 2013, the balance of the credit facilities consisted of $11,801 of existing drawn facilities which were extended in term, an existing $3,000 operating line of credit which was undrawn, and added $27,000 in new senior term debt facilities which is available to support investment in the Company's enhanced business plan. These facilities are principally secured by a general security agreement over the Company's assets.

The amended facilities available to the Company are for the following corporate purposes:

- $3,000 operating line of credit that bears interest at a floating rate of prime plus 1.65%;
- $5,250 used to repay the drawn portion of TeraGo's previous senior term credit facility, which bears interest at the rate of 4.74% and is repayable in monthly principal installments of $125 starting October 2011 and matures

(In thousands, except for per share amounts)

September 2016. This facility is fully drawn;

- $3,541 used to finance a previous acquisition of which $2,569 bears interest at 4.61% and $972 bears interest at 3.97% and is repayable in monthly principal installments of $92 starting June 2011 and matures May 2016. This facility is fully drawn;
- $2,104 used for general working capital purposes to fund continued growth of which $704 bears interest at 4.31% and $1,400 bears interest at 4.35% and is repayable in monthly principal installments of $75 starting April 2012 and matures August 2015. This facility is fully drawn;
- $906 used for general working capital purposes to fund continued growth, which bears interest at the rate of 3.98%, is repayable in monthly principal installments of $31 and matures August 2015. This facility is fully drawn;
- $8,000 to finance capital expenditure investments and related expenses in respect of new fibre and wireless network builds including upgrades repayable in monthly installments of $133 once fully drawn. In December 2013, $918 was drawn for capital expenditure investments which bears interest at 4.30% and is repayable in monthly principal installments of $15 starting January 2014. In January 2014, $557 was drawn for capital expenditure investments which bears interest at 4.17% and is repayable in monthly principal installments of $9 starting March 2014;
- $6,000 to finance capital investments and related expenses for new fibre networks for municipalities, utilities, schools, hospitals or other business/ enterprise customers repayable in monthly installments of $100. This facility is undrawn as at March 31, 2014;
- $13,000 to finance acquisitions repayable in monthly installments of up to $217 once fully drawn. On May 31, 2013, $9,500 was drawn for the purchase of Data Centres Canada Inc. which bears interest at 4.17% and is repayable in monthly principal installments of $158 starting June 2013.

For the undrawn facilities, TeraGo has the option of choosing floating interest rates, ranging from prime plus 1.80% to 1.95%, or a fixed rate once they are drawn.

No amounts have been drawn on the $3,000 operating line of credit as at March 31, 2014 (December 31, 2013 – $nil).

(ii) Equipment loans

The Company entered into certain equipment loans with financing companies that are secured by the underlying equipment. These debt facilities, which bear interest at fixed rates ranging from 5.97% to 6.23% over the respective terms, have total monthly installments of $29.

9. Other Long-Term Liabilities

	March 31 2014	December 31 2013
Performance-based Share Units (Note 10 (iii))	$ 20	$ 282
Restricted Share Units (Note 10 (ii))	$ 12	$ -
Finance lease obligations	-	3
Assumed liabilities - Vancouver Data Centre	588	579
	620	864
less: current portion	(18)	(237)
	$ 602	$ 627

10. Stock-Based Compensation

(i) Stock Options

For the three months ended March 31, 2014 and 2013, the Company recorded stock-based compensation related to stock options of $112 and $nil, respectively. On March 3, 2014, the Company granted 262 Options under the 2007 Option Plan to an officer of the Company at an exercise price of $5.77 per share.

On January 9, 2014, the Toronto Stock Exchange (the "TSX") approved the Company to allocate 229 options which were to fall outside of the 2007 Option Plan subject to certain pre-conditions. On March 3, 2014, the Company granted 229 Options from this reserve to an officer of the Company at an exercise price of $5.77 per share. On March 6, 2014, the Company secured confirmation from the TSX that the pre-conditions had been satisfied and the option grant approved.

(In thousands, except for per share amounts)

A summary of the status of the Company's stock option plan as at March 31, 2014 is presented below.

	Number of Options	Weighted Average Exercise Price
Outstanding - January 1	1,045	$7.11
Granted	491	$5.77
Exercised	(84)	$3.63
Outstanding - March 31	1,452	$6.86
Exercisable	961	$7.41

The Company estimated the fair value of all options issued using the Black-Scholes option-pricing model. The fair value of the options and the assumptions used to determine fair value on the dates of issue were as follows:

Period	Weighted Average Strike Price	Weighted Average Expected Life (years)	Weighted Average Expected Volatility	Weighted Average Risk-free Interest Rate	Weighted Average Fair value of Options
2014	$5.77	9	40%	2.19%	$2.89

(ii) Restricted Share Units (RSUs)

On March 12, 2009, the Company established a RSU Plan which is available to our directors, officers, and full-time employees approved by the Board. In the first quarter of 2014, the Company granted 150 RSUs to an officer of the Company. The share price at the date of grant was $5.35 and will be marked to market on a quarterly basis. The value of one RSU is equal to the value of one Common Share. Plan participants are granted a specific number of RSUs for a given period based on their position and level of contribution. At the end of the three-year vesting period, the RSUs vest if the plan participant is employed by the Company. Vested RSUs are expected to be paid in cash or Common Shares purchased on the open market, or a combination of both, as the Company chooses. All RSUs under this Plan will vest immediately on a change of control of the Company.

For the three months ended March 31, 2014, the Company recorded compensation expense of $12 (March 31, 2013 - $nil) related to the RSUs granted. As of March 31, 2014, a liability of $12 related to the RSUs granted is included in Other long-term liabilities.

The following table is a summary of the number of outstanding RSUs as at:

	March 31 2014	December 31 2013
Opening Balance	-	-
Granted	150	-
Vested	-	-
Ending Balance	150	-

(iii) Performance-based Share Units (PSUs)

Plan participants are granted a specific number of PSUs for a given period based on their role within the Company and level of performance. At the end of the three-year vesting period, the PSUs vest if the plan participant is employed by the Company and certain non-market performance criteria are met. Vested PSUs are expected to be paid in cash or Common Shares purchased on the open market, or a combination of both, as the Company chooses. All PSUs under this Plan will vest immediately on a change of control of the Company. The PSUs are re-measured to fair value each reporting period. The value of one PSU is equal to the value of one Common Share.

On March 2, 2014, 33 PSUs vested and the Company paid cash of $207 to settle the awards based on a weighted share price of $6.29 per award.

(In thousands, except for per share amounts)

For the three months ended March 31, 2014 and 2013, the Company recorded stock-based compensation of $(55) and $(58), respectively, related to the PSUs outstanding. As at March 31, 2014, a liability of $20 related to the PSUs granted is included in Current liabilities and Other long-term liabilities (Note 9).

The following table is a summary of the number of outstanding PSUs as at:

	March 31 2014	December 31 2013
Opening Balance	66	213
Granted	-	54
Exercised	(33)	(89)
Forfeited/ Expired	(21)	(112)
Ending Balance	12	66

(iv) Stock-Based Compensation Summary

The following table is a summary of the stock-based compensation:

	Three months ended March 31	
	2014	2013
Restricted share units	$ 12	$ -
Performance-based share units [1]	(55)	(58)
Stock options (Note 7)	742	-
Directors' Fees paid in shares	52	45
	$ 751	$ (13)

[1] The Company's stock price decreased from $6.61 at December 31, 2013 to $4.93 at March 31, 2014 resulting in a recovery related to the re-measurement of Performance-based share units that are recorded at fair value each period end, in addition to the reversal of previous recognized compensation for awards forfeited prior to vesting.

11. Earnings Per Share

The following table sets forth the calculation of basic and diluted earnings per share.

	Three months ended March 31	
	2014	2013
Numerator for basic and diluted earnings per share:		
Net earnings for the period	$ (1,093)	$ 1,340
Denominator for basic and diluted earnings per share:		
Basic weighted average number of shares outstanding	11,490	11,397
Effect of stock options, RSUs and PSUs	-	563
Diluted weighted average number of shares outstanding	11,490	11,960
Earnings per share:		
Basic	$ (0.10)	$ 0.12
Diluted	$ (0.10)	$ 0.11

Due to the loss for the three months ended March 31, 2014, the impact of all options, RSUs and PSUs totaling 974 were excluded from the calculation of diluted earnings per share because they were antidilutive.

For the three months ended March 31, 2013, the effect of stock options totaling 413 were excluded in the calculation of diluted earnings per share because they were antidilutive.

(In thousands, except for per share amounts)

12. Fair value of financial instruments

The Company has determined the estimated fair values of its financial instruments based on appropriate valuation methodologies. These methodologies are described in note 20 of the 2013 Consolidated Financial Statements.

The Company has classified its financial instruments as follows:

	March 31 2014		December 31 2013	
	Carrying amount	Fair Value	Carrying amount	Fair Value
Financial assets:				
Loans and receivables, measured at amortized cost				
Cash and cash equivalents	$ 878	$ 878	$ 2,137	$ 2,137
Short-term investments	73	73	452	452
Accounts receivable	2,945	2,945	2,933	2,933
Restricted cash	821	821	821	821
Financial liabilities, measured at amortized cost:				
Accounts payable and accrued liabilities	7,946	7,946	6,008	6,008
Long-term debt	18,211	18,211	19,112	19,112

13. Related Party Transactions

The Company provides services to one customer whose Chairman of the Board of Directors is one of the Directors of the Company. Revenue from this customer for the three months ended March 31, 2014 and 2013 was $16 and $13, respectively. Accounts receivable from this customer as at March 31 2014 was $4 (2013 - $nil).

The terms governing these related party transactions are consistent with those negotiated on an arm's length basis with non-related parties.

14. Subsequent Events

In May 2014, the Company signed a commitment letter with National Bank of Canada and RBC for Credit Facilities totaling $50,000, consisting of a $5,000 revolving operating credit facility, a $20,000 non-revolving term credit to repay the drawn portion of the existing credit facility and a $25,000 non-revolving acquisition and capital expenditure facility (collectively, the "Credit Facilities"). The Credit Facilities would replace TeraGo's existing debt facilities with RBC (Note 10) and are expected to close prior to May 31, 2014.