

FINAL TRANSCRIPT

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LWSN - Q3 2007 Lawson Software, Inc. Earnings Conference Call

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PRESENTATION

Operator

Good afternoon, and thank you, all, for standing by. All participants are in a listen only mode until the question and answer session of today's conference. Today's call is being recorded. If anyone has any objections please disconnect at this time. I will turn the call over to your conference host, Ms. Barbara Doyle, Vice President of Investor Relations. Ms. Doyle, you may begin.

Barbara Doyle - Lawson Software, Inc. - Vice President Investor Relations

Thank you, and good afternoon to everyone on the call. Welcome to Lawson Software's third fiscal quarter 2007 conference call. On today's call, we have Harry Debes, Lawson's President and Chief Executive Officer; Rob Schriesheim, Lawson's CFO and Stefan Schulz, Lawson's Global Controller. We will provide our comments regarding Q3 results and future guidance and then we will open up the call to your questions as the Operator described.

Let me remind you that you can reference our press release on our investor website at www.lawson.com/investor. I also remind you that we have several supplemental investor spreadsheets posted on our IR website to further aid your review of our results. Now, please let me review the Safe Harbor statement.

This call will include forward-looking statements that contain risks and uncertainties. These forward-looking statements contain statements of intent, belief, or current expectations of Lawson Software and its management. Such forward-looking statements are not guarantees of future results, and involve risks and uncertainties that may cause actual results to differ materially from the potential results discussed in these forward-looking statements. The Company is not obligated to update forward-looking statements based on circumstances or events that occur in the future. Risks and uncertainties that may cause such differences include, but aren't limited to uncertainties in the Company's ability to realize synergies and revenue opportunities, from the Intenia acquisition, uncertainties in the software industry, uncertainties as to when and whether the conditions for the recognition of deferred revenues will be satisfied, global military conflicts, terrorist attacks on the United States or any future events in response

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to those developments, changes in the condition of the Company's targeted industries, increased competition, and other risk factors listed in the Company's recent 10-Q and 10-K filed with the Securities and Exchange Commission, and available on our website. With that, let me turn the call over to Harry Debes.

Harry Debes - Lawson Software, Inc. - President, CEO

Thank you, Barbara, and good afternoon, everyone. Here is what we'll cover today. First, I'll provide a summary of Q3 results and a recap of some recent announcements, and after that, Rob Schriesheim, our CFO, will review the quarter in more detail and will provide guidance on Q4. So let's begin.

Q3 marks the third full quarter of the new Lawson post Intertec acquisition. Integrations and transformations of the scale we've undertaken take time and patience. In the first two quarters, although we were making good progress, that progress was not reflected in our financial results. However, our third quarter results are more reflective of where we really are in that transformation. During Q3, we sold more software, we sold and delivered more services and we re-signed more maintenance agreements than ever before. Although contracting was not as high as we wanted it to be, it did grow by 3% sequentially to \$31 million, and this is the third consecutive quarter of contracting growth.

License revenue was higher than forecast, due to higher contracting, higher conversion rates, and because we met the milestones on projects previously sold and were therefore able to recognize some deferred license revenue. This should not be a surprise because we told you that over time, this would be happening and now we are starting to see the tangible results.

Our near term and long term sales pipeline continues to grow, increasing each quarter since we've closed the merger. Both Americas and EMEA pipelines showed sequential increases again this quarter, and because of the opportunity in our pipeline, we continued our salesforce hiring campaign. In Q3, our quota carrying salesforce increased 14%. After ending Q2 at 171 account executives, we executed well on our hiring plans and ended the third quarter with 194 AE's. As of today, we have just over 200 AE's in the field. And because of our solid pipeline and the increasing number of salespeople, we expect that license contracting and license revenue will continue to move in a positive trend line, but as we've said before, there may be some near term volatility due to various seasonal effects such as European vacations in our first quarter.

Now, let me give you some color on the signings in the third quarter. We signed a total of 354 deals in Q3. We added 24 new customers for a total of 85 new end deals year-to-date. Five deals in the quarter were greater than \$1 million and four deals were between \$500,000 and \$1 million. Year-to-date, 36% of our licensed contracting was with new accounts and 64% was with existing customers. The largest M3 deal of the quarter was with Bygma, a Danish building supplies company where we beat Oracle. In our fashion and apparel vertical we beat SAP to win Quiksilver, a Japanese based surfwear company. We also beat SAP to win Belle Footwear, China's largest footwear retailer with more than 3,000 stores across China, Hong Kong, and the United States. Bunzl Vending Services, the UK's largest vending operator selected Lawson's M3 suite over Oracle and other best-of-breed vendors. And in the Americas, we added Koramsa, a fashion manufacturer in Central America where we beat SAP.

Our largest S3 deal was a win over Oracle and SAP at Pinnacle Airlines. In Healthcare we beat McKesson to sign Crittenton Medical Center, a community hospital. Holland Community Hospital and Wentworth Hospital were the other notable wins in healthcare this quarter. We beat Oracle-PeopleSoft at Veteran's Health Administration who chose to standardize on Lawson as their single human capital manager vendor thereby displacing the existing Oracle-PeopleSoft systems. In our Government and Education vertical, we beat Oracle to sign Montgomery Waterworks and Sanitary Sewer Board and we also beat Oracle to sign Tacoma School who licensed all of our S3 application suites as well as the M3 Enterprise Asset Management suite. And finally in our Financial Services vertical, our human Capital Management suite was selected by First National Bank of Omaha to replace disparate ADP systems.

Now, I want to briefly discuss our other business segments. Maintenance renewals and collections were strong in our third quarter, about 2/3 of our M3 maintenance contracts came due for renewal on January 1. Of these invoices, \$45 million of cash,

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the equivalent of 50% of our anticipated annual M3 maintenance renewals was collected. Now, in Q4, with most S3 contracts due for renewal at the end of this quarter, we are in the midst of renewing the S3 customer base. Invoicing occurred in March so that Q4 will be the main collection quarter for S3 maintenance revenue. As we've been saying all year, the maintenance collection quarters of Q3 and Q4 will have a positive impact on cash flows and that is proving to be the case.

Consulting revenues which consist primarily of business consulting services and \$2 to \$3 million of hardware revenue declined slightly, less than 1% as a result of lower hardware sales. We had \$2.5 million of hardware revenue in Q3, but we've been making a conscious decision to reduce our hardware business so this is not surprising or disappointing. This business consulting revenues net of hardware increased slightly as customers increasingly see the value of Lawson's services offerings. More importantly, services margins improved to a healthy 17.7% in Q3, and this is with only 3% of the billable hours being delivered from Manila. In fiscal '08 as we continue to grow our capacity in Manila, we expect to increase the work being completed there and this will continue to drive better services margins over time.

Finally, I'm also pleased that we were able to maintain good control over our costs. And with the restructuring plan that was undertaken, I'm confident that future quarters will benefit from the actions taken in Q3. Rob will cover more of this detail in his discussion of Q3 results and Q4 guidance, but as is clear from the earnings release, Q3 showed good progress. Now I'd like to speak briefly about our annual customer conference which was held in San Diego in early March.

We had a strong turnout of M3 and S3 customers with approximately 4,700 customers attending, up more than 10% from 2006. On the main stage, we highlighted Catholic Healthcare's West successful Lawson implementation and Go-Live after a failed SAP project and the State of Michigan's "2006 Recognition Award for Outstanding Achievement in the Field of Information Technology in State Government", and that was from the National Association of State Chief Information Officers for the successful Lawson Human Capital Management implementation. We also showed what some of our customers were doing with Lawson Business Intelligence and how they utilize these tools to make operational business decisions. The number of partner exhibits at the conference almost doubled over last year, reflecting increased interest in Lawson's solutions and also our intent to increase the partner ecosystem that surrounds our offerings.

And we made some important announcements this quarter. When the merger closed we promised M3 customers that Lawson would continue to develop the M3 product line. The announcement of M3 version 7.1 in March is proof that we are delivering on our promises. This is the first new M3 released in several years and we have included more than 100 new vertical specific features which make M3 more competitive. We are also applying lessons learned from our S3 experience into this release and for the first time we are separating M3 technology from M3 applications. We are delivering brand new technology middleware called Lawson System Foundation for M3 which allows customers to advance to technology without needing to change their applications.

Separating that technology decisions from the applications decisions, substantially reduces our customer's ownership costs going forward. Like Lawson System Foundation for S3 which has now shipped to 450 customers since its availability last year, Lawson System Foundation for M3 bundled IBM Web Sphere Application Server, Tivoli Directory Server and DB2 and is the basis from which we help our customers move to a services oriented architecture. Furthermore we recently expanded our System Foundation bundle to now include IBM Web Sphere Enterprise Service Bus and IBM Web Sphere MQ thereby delivering more value to our clients.

Next Lawson announced an important new reseller agreement with IBM. Under this agreement, Lawson and IBM will focus on the fashion, food and beverage, banking and insurance sectors. To penetrate these markets, IBM will develop industry specific solution bundles based on Lawson's enterprise applications. We think that this agreement has the potential to dramatically increase license sales into these target segments, as we are impressed by IBM's enthusiasm for this opportunity. Lawson also announced a new partnership with The Revere Group to target retail and manufacturing firms in North America. And finally, we announced Lawson's Total Care Platinum, a hosting service wherein Lawson will host our applications on behalf of our customers thereby reducing the complexity of managing their IT systems. This hosting solution is offered in conjunction with IBM.

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Then, after the customer conference in San Diego, several Lawson executives traveled to Scandinavia to meet with regional user groups where we were able to repeat the key messages and share our new announcements with the 800 or more customers we have in that part of the world. The feedback from customers globally has been very positive about the progress the new Lawson is making operationally and also on delivery on our product vision.

So in summarizing our third quarter, I would say that we made progress on a number of important fronts and this progress is now finally beginning to be reflected in our financial results. In the maintenance renewals and from the interest in our new product announcement, we also have tangible evidence of the confidence that our customers have in the new Lawson and that bodes well for our future. Now, I will turn the call over to Rob Schriesheim, who will share more details of our operating and financial performance.

Rob Schriesheim - Lawson Software, Inc. - CFO

Thank you, Harry. I will first provide an update on our purchase accounting review which was the reason for the delay of our conference call. The SEC, as you probably know, allows a year to finalize purchase accounting transactions due to the nature of the process. The purchase accounting for Intenia is quite complex and involved hundreds of accounting entries. We conducted an extensive review of the transaction which resulted in an increase to goodwill of \$21.4 million primarily related to adjustments for accrued liabilities. The purchase accounting for Intenia is now substantially complete with two items remaining. The Company may need to make subsequent purchase accounting adjustments in Q4 for Value Added Taxes or VAT, in Europe, and for refinements to litigation reserves for Intenia customer claims made prior to the acquisition date. Both of these items will be settled with appropriate adjustments made in the May quarter at which time our purchase accounting will be 100% complete.

Let's move on to review of our quarterly results. The analysis I will provide will focus on non-GAAP measurements for the purposes of this call. We have a complete reconciliation of GAAP and non-GAAP measurements in our press release and also on our website and you should review that. Also, I'll focus on sequential comparisons between Q2 '07 and Q3 '07 because they provide the best view of the business results this first year after the merger. Year-over-year comparisons are provided in the 10-Q for your review.

I'm comfortable with the progress made toward our operating and financial goals in Q3. Total software license contracting increased sequentially to \$31 million, so not as much as we had expected when we gave our Q2 guidance range of \$32 million to \$38 million. As I've indicated many times, quarterly contracting is volatile and especially so since we continue to build our global sales organization under consistent and uniform practices, however, we manage the business well and slightly exceeded the financial expectations we outlined in our conference call on January 9. We had total revenues of \$193 million compared to our guidance range of \$183 to \$190 million. Non-GAAP EPS of \$0.06 per share includes \$0.02 per share of favorable impact due to a lower than forecasted effective tax rate of 37% in the quarter. Holding the tax rate constant at the forecasted 58%, EPS would have been \$0.04 compared to our \$0.02 to \$0.03 guidance range. I'll speak more about taxes in a moment.

Overall, we improved from Q2 but we still have a lot of work ahead of us as we continue to build the sales organization while executing on our various transformational initiatives. Non-GAAP revenues of \$193 million include \$1.8 million of maintenance and consulting revenue impact resulting from the purchase accounting write-down. Total non-GAAP revenues increased 2% from Q2. The mix of revenues by geography changed only slightly from Q2. Revenues from the Americas region represented 54% of total revenue for the quarter. Europe, Middle East, and Africa regions represented 43% of total revenue and Asia Pacific revenue represented 3% of total revenue for the quarter.

License revenue increased to \$26.4 million in Q3 reflecting a 20% sequential improvement. License revenue increased to approximately 14% of total revenue from 12% in Q2. The sequential increase in license revenue was driven by three primary factors: a 3% growth in software contracting in the quarter, a lower deferral rate on S3 contracts, and an increasing benefit to revenue from software sales made earlier this year. Let me review this piece in a little more detail.

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In the first two fiscal quarters this year, the suppressive income statement impact of license deferrals, particularly on our M3 business, was significant. In Q3, however, we had a more neutralized balance between current quarter deferrals and revenue that we could recognize in the quarter from the deferred account. This was the first time this year where the roll in began to have more of an impact. Recognizing deferred revenue is not done in an arbitrary manner nor was there anything unnatural done during the quarter to benefit license revenue. It is a function of meeting terms or milestones on a contract by contract basis and it will vary each quarter. As we said, we fully expect the ins and outs between current quarter defers -- deferrals and roll in from the balance sheet will reach a state of dynamic equilibrium and the suppressive impact we saw in the first half of this fiscal year will diminish. Even as we were able to recognize more deferred revenues in the quarter, we still added to the net deferred license revenue account. Deferred license revenues at the end of Q3 were \$33 million, up from \$29 million at the end of Q2.

Now for professional services. Total services revenues of \$91.9 million decreased slightly from Q2 as a result of lower hardware revenues as we continued to exit the hardware reselling business. Consulting revenues net of \$2.5 million in hardware increased slightly in the quarter. As a percent of total revenues, services revenue were 47% of total revenues in Q3 versus 49% in Q2. Maintenance revenue continues to be steady and predictable. Q3 maintenance revenue of \$74.7 million held steady at 39% of total revenue. S3 customer renewals remain robust, and we continue to focus equally on M3 customer support with the plan to achieve similar levels of customer satisfaction and renewals for these customers. The combination of increased revenue with healthy renewal rates demonstrates the value that our customers place on our support services.

Some comments on costs and gross margins. Total Q3 cost of revenues were \$93.8 million, 1% lower sequentially even as revenues increased 2%. Obviously, that's a good combination that yields improved gross margins. The benefit was driven by license and consulting margins. Total non-GAAP gross margin increased about 100 basis points to 51%. License margins increased to 87.9% from 85% driven primarily by margin on third party content. Services margin improved to 17.7% up from 15.3% in Q2 and about 12.8% in Q1. The 240 basis point improvement over Q2 was driven by a smaller percent of services performed by third party subcontractors and a smaller amount of low margin hardware sales. Some of this is a unique benefit in the quarter and may not recur but overall, the consulting margins are moving in a positive trajectory towards the 20% goal that we have outlined. Maintenance margin of 80% declined slightly from 82% in Q2 driven by increased staffing primarily in Manila and Europe as part of our investment in customer facing resources.

As we discussed on last quarter's call, we are making key investments in global infrastructure and customer facing resources balanced by global operating and cost efficiencies with the objective of keeping quarterly expenses at or below \$180 million net of restructuring. With collective management focus across-the-board, total Q3 non-GAAP expenses were \$176.2 million. Departmental operating expenses of \$82.4 million increased 2% for Q2. As a percent of revenue, however, total operating expenses held constant at 43% of revenue. Sales and marketing spending of \$39.5 million increased 1% over Q2 but declined slightly as a percentage of revenues to 20% from 21% in Q2. R&D spending decreased 10% from Q2 to \$20.2 million reflecting some immediate benefit of our plans to centralize our R&D into three primary global development centers in Saint Paul, Stockholm, and Manila. The savings in the quarter were driven by headcount reduction as well as by the consolidation of multiple offshore partners in India. In the other direction, G&A expense increased 19% over Q2 to \$22.8 million. This increase was driven by higher employee expenses particularly in our international operations. As we've discussed, G&A expenses will be high during the integration.

Non-GAAP operating income was \$16.8 million or 8.7% compared with 7% operating margin in Q2. The benefit was driven by a 2% growth in revenue while total expenses increased less than 1% quarter-over-quarter. That's good progress on our operating margin. This is a good place to pause and review the status of our global sourcing initiatives. We've accelerated our hiring in Manila, increasing our staff 37% in Q3 to a total of 247. Building and training our team in Manila is critical to the pace at which we can pursue our transformational initiatives. We are making good progress and plan to grow our Manila operations by approximately another 500 employees by the end of FY '08.

As we build our Philippine staff, we plan to move approximately 350 positions from North America and Europe to Manila over the course of fiscal '08. This is approximately 10% of our current employees. The majority of the positions will be in our services

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and R&D areas but eventually all functional areas will be represented in Manila. We announced this restructuring in an 8-K on March 7, and we recorded a restructuring charge of \$11.5 million primarily for employee costs and severance in the quarter for this activity. We began this restructuring in Q3 incurring \$600,000 of severance and employee benefits in the quarter.

As we have disclosed it will take us six to eight quarters to complete this effort and we are still early in the process, because this is a process that needs to be carefully balanced to ensure stable customer support and managed migration of intellectual assets we will incur some duplication of expenses over the next few quarters. We will be essentially running dual staffing in some areas for periods of time in fiscal '08 as we staff, hire, and train in Manila. We have made excellent progress in the last three to four months in getting the initiative in place. We don't have specific guidance for you for FY '08 at this time but this is a process that does not yield a straight line of cost savings each quarter, and will likely result in a short-term profitability impact during the early part of fiscal '08. But at the end of the process, we will substantially have changed the cost structure of the Company with expense savings of 300 to 400 basis points net of restructuring costs and we expect to fully realize these benefits in FY '09. As we've stated, we also intend to continue adding resources in our sales services and customer support area in FY '08 that will also offset some of the savings from our global rebalancing. Our objective however is to hold our FY '08 total expenses to less than 5% growth in fiscal '08 net of restructuring costs.

We will factor all the short-term costs and savings into the quarterly guidance we provide and we will keep you updated on the progress. We also anticipate possible further actions as we continue our integration including the build out of our European shared services center which may result in other charges that are not possible to predict at this stage.

Back to the income statement. Net other income of \$1.4 million declined from \$3.3 million in Q2, the decline was primarily driven by \$1.2 million of interest expense reported in the quarter for adjustments to accrued liabilities associated with the purchase of Intentia. These adjustments were part of the finalization of the purchase accounting process we conducted in the quarter. Net interest income declined slightly from \$3.7 million in Q2 to \$3.3 million in Q3, reflecting a slight decline in average investment balances between the two quarters.

Now I'll comment on our taxes. We have reduced the FY '07 effective tax rate estimate as we are beginning to see improvement in the mix of U.S. and non-U.S. profitability, with our profit forecast and our plans proceeding with global restructuring we have more comfort that our tax rate will come down this year. Taxes also benefit from the retroactive reinstatement of the R&D tax credit and some other discrete items discussed in our 10-Q. As a result our Q3 non-GAAP tax provision was \$6.8 million or a 37% effective tax rate. As I mentioned, this lower tax rate benefited our non-GAAP EPS by \$0.02 in the quarter compared to our guidance assumptions of a 58% effective tax rate.

Our new full year and Q4 tax rate estimate for non-GAAP for your modeling purposes would be 51%. On a full year basis, our lower tax assumptions benefit FY EPS by about \$0.025 relative to the guidance we provided during January's call. Tax rates remain volatile and can swing our EPS forecasts, but I am pleased to see the effective tax rates beginning to stabilize. Our expectation continues to be to see further reduction in tax rates in FY '08 as our operational plans and global synergies are achieved.

We utilized \$5.9 million of our \$100 million buyback authorization during the third quarter to repurchase 867,000 shares at an average price of \$6.80 per share. Including the benefit of the shares repurchased in the quarter, our basic weighted average shares outstanding were 187.7 million and our fully diluted weighted average shares outstanding were 190.8 million. As a matter of routine course, the Company continues to evaluate our capital structure in the context of our operating plans, cash flows, and market conditions.

Cash flow turned positive in the quarter as we generated \$14.8 million of cash flow from operations compared with a \$14 million net use of cash in Q2. The improvement in cash flow was driven by a very successful collection rate on international maintenance renewals. We collected \$45 million of cash for international maintenance renewal contracts that were realigned to a January 1, renewal date that we have discussed at length. This is about half of our anticipated annual international maintenance revenues which was at the top end of what we expected we could get collected. Our cash and equivalents increased to about \$286.1

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million from \$278.8 million at the end of Q2. Our cash balance includes \$15 million of restricted cash primarily related to the settlement for the purchase of remaining outstanding shares of Intentia. I would also reiterate our expectations that the large cash inflow anticipated in Q4 and Q1 from the U.S. customer maintenance renewals realigned to a June 1, renewal date, should add substantially to our cash balance.

Now for some commentary for our financial guidance for our fiscal-fourth quarter. Our goal is to develop consistency in setting prudent guidance and then doing what we said we were going to do. We are pleased that we met or slightly exceeded the financial guidance ranges we provided last quarter and continued to make progress on our contracting. I don't have to tell you that this is rarely a lay-up in the software world and becomes even more difficult when you add the complexities of a major merger and major business transformation on top of things. But we will strive for that goal. At the beginning of fiscal year we indicated that we would provide quarterly license contracting amounts in order to provide more visibility into the business during the transition period following the merger. Consistent with this approach and since licensed deferrals are becoming more neutralized, we will no longer provide software contracting guidance. This is not only a very difficult estimate to pin down for software, at least well enough for a guidance range. It is a competitively sensitive metric. Therefore, we do not intend to provide this guidance on licensed contracting going forward. So with that said let me give you some Q4 guidance.

We anticipate total non-GAAP revenue of between \$188 million and \$196 million as follows--License revenues of between \$24 million and \$28 million, maintenance between \$74 million and \$75 million; consulting between \$90 and \$93 million. While we do plan for a sequential increase in total expenses in our fiscal fourth quarter, we maintain an objective of keeping quarterly expenses at or below \$180 million on average net of any restructuring expenses consistent with what we said in our Q2 call in January. Total GAAP revenues including an impact of purchase accounting on our consulting and maintenance revenue is estimated at about \$1 million should be between \$187 million and \$195 million. GAAP EPS is anticipated to be between a net loss of \$0.02 per share to net earnings of \$0.03 per share. There is a wide range of GAAP results, driven by the merger and integration cost as well as volatile tax rates. On a non-GAAP basis excluding these impacts which most of you model, EPS is expected to be \$0.03 to \$0.05 per share excluding \$8.8 million of pre-tax non-recurring non-cash items at an anticipated effective tax rate of 51%. With that, let me turn the call back over to Harry.

Harry Debes - Lawson Software, Inc. - President, CEO

Thanks, Rob. Well, as you've heard, three quarters into this combination of Lawson and Intentia, we are making good, steady progress on our financial goals and customer commitments. We now have our arms around most of the integration and transformation issues. We have the commitment of our employees and the confidence of our customers. We have developed and shipped significant new products which make us more competitive in the market. By beating Oracle and SAP 30 times or more every quarter in new account situations, we have demonstrated that we are a legitimate, lower cost and lower risk alternative.

Despite an unbelievably complicated combination we have shown that we can improve the revenue and operating income of this business every quarter. So right now, the entire Lawson team is feeling that while we still have a lot of work ahead of us, much has been accomplished and we are proud of that accomplishment. We continue to feel bullish about our position in the market and we look forward to a less complicated and strong FY '08. That concludes today's comments and operator; we are now ready to take some questions.

QUESTIONS AND ANSWERS

Operator

[OPERATOR INSTRUCTIONS] Looks like our first question is coming from Tom Ernst of Deutsche Bank.

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Tom Ernst - Deutsche Bank - Analyst

Good afternoon, thank you, gentlemen.

Harry Debes - Lawson Software, Inc. - President, CEO

Hi, Tom.

Tom Ernst - Deutsche Bank - Analyst

Harry, you started out talking about how this quarter is more representative. I don't think or if you did say it I missed it, you talked about the conversion rate on the M3 side of the business as well. So just a couple questions for you. When it's insane is it more representative, are we through that process of getting kind of apples-to-apples comparisons at this point or is there more? Can you give us the conversion rate? And then as a follow-up to that, the maintenance growth seems pretty remarkable, particularly on the back of the weaker first half in terms of contracting. I'm wondering how sustainable the growth is in the level we're seeing in the maintenance revenues to look forward.

Harry Debes - Lawson Software, Inc. - President, CEO

Okay, so Tom, on your first question, on conversion rates, the conversion rate really hasn't changed that much. We're still in the approximately 50% range when it comes to M3, so there's, we're still dealing with that and I don't think that that's going to change dramatically over the next year either. So what I meant by be more normal is that we're now showing that we're having not only deferrals normal, but also we're getting the benefit of the roll in and that's what we're sort of looking forward to next year because you remember at the beginning of this fiscal year, the year we're in right now, we didn't have a deferred licensed revenue balance as far as the M3 business is concerned, a very small one on the S3 side. So we weren't the beneficiaries of making any withdrawals from our balance sheet to our P&L, we were simply making these deposits, and we're finally starting to see that level out and as Rob mentioned in his comments, I think in the future, we're going to see this dynamic, what did you say? Dynamic?

Rob Schriesheim - Lawson Software, Inc. - CFO

Equilibrium.

Harry Debes - Lawson Software, Inc. - President, CEO

Dynamic equilibrium of the license revenue which approximately equates to the ins versus the -- equals the outs so that's what I meant about normal. On the second question, maintenance revenue growth, no, I think our maintenance revenue growth has been growing steadily every quarter, and we've put together some very specific targeted programs first of all to increase maintenance, secondly to retain our customers, thirdly to add additional products and services so that we can offer them a wider range of services. For example, total care, last year we announced Total Care Bronze, Silver and Gold, different, elevated service levels, broader levels of services for a premium price, and just recently we announced Platinum which is another level of service, again, and we're seeing some good acceptance amongst our customers. So the question of is it sustainable? We certainly have plans to -- by the way these programs were just recently announced so they aren't fully deployed. Customers are still engaging with us, understanding the definition of these new offerings, and we are now proposing them more frequently. So, I do believe that at least for the next several quarters, we will continue to have positive momentum in our maintenance business.

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Tom Ernst - Deutsche Bank - Analyst

Great. And one follow-up, if you'll permit. Back to the stability question: I think I asked you more about the accounting side but on the business side over the last a little bit over a year you've changed the direct and indirect organizations pretty significantly and the partners you work with pretty significantly. Do you feel like you've gotten to a stable level of productivity or do we still have more gains potentially to follow those changes you've made?

Harry Debes - Lawson Software, Inc. - President, CEO

On the services business, specifically, if that's what you're talking about the productivity level of our services organization, I think that there's still more upside in the maintenance as the Manila facility becomes more productive, because don't forget, we started a year ago with no people over there. We have a few dozen people in place, trained, and delivering work today, but it's less than 3% or approximately 3% of our hours are being delivered from Manila today, but our backlog is growing at a tremendous rate, and so we have aspirations of eventually doing between 18% and 20% some of our billable work from Manila. We would like to see that in 12 or 15 months from now, we would like to see that kind of a delivery mechanism and by having that in place and achieving that goal, we think we can improve our maintenance margins beyond where we are today.

Tom Ernst - Deutsche Bank - Analyst

I guess Harry I was asking more on the sales side on the distribution side both the indirect channel because you've made a lot of changes in the channel?

Harry Debes - Lawson Software, Inc. - President, CEO

Oh, I'm sorry. I misunderstood your question.

Tom Ernst - Deutsche Bank - Analyst

That's okay.

Harry Debes - Lawson Software, Inc. - President, CEO

So we have announced some new partnerships. A number of resellers, we announced some resellers in certain Eastern European countries, in certain parts of Asia and recently, IBM has become a reseller. I would tell you that those relationships and initiatives are fairly new, and so they're just really getting off the ground, and so we haven't been able to see any real gains from them at this point, but I do expect that that will happen in the future.

In terms of the direct sales productivity, so the answer is we've increased our sales headcount dramatically over the last year. I think everybody recognizes that when we add new people it's going to take them about 6 to 9 months to really come on stream and that's pretty much what's happening. So I'm pleased with first of all, the quantity and secondly, the quality of the people that we've brought on board. I can see it in the pipeline and the pipeline growth is the best indicator of what you're going to be, what you should expect to see in 6 to 12 months from now and so I'm very encouraged by what I see about both short and long term pipeline.

Tom Ernst - Deutsche Bank - Analyst

Great. Thank you, again.

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Harry Debes - Lawson Software, Inc. - President, CEO

Okay, pleasure.

Operator

Our next question comes from Peter Goldmacher of Cowen & Co.

Peter Goldmacher - Cowen & Co. - Analyst

Hi, guys. Just wanted to ask you two quick questions. First, on the increase in deferred revenues from Intenia I think you had mentioned that you collected about half of what you thought you could collect, so is it right to infer that there could be as much as \$45 million more just from Intenia in the May quarter and is it appropriate to extrapolate your success with Intenia for what we can expect from the Lawson business, and is it, are we getting ahead of ourselves if we think that it could be as much as between \$140 and \$150 million increase in deferred revenue for the May quarter increase?

Harry Debes - Lawson Software, Inc. - President, CEO

Well, Peter let me just clarify. We didn't collect half of what we thought we would. What we collected was \$45 million which was actually at the high end of what we thought we would collect in that quarter. The total Intenia business is approximately \$90 million worth of maintenance, but not all of it was renewable on the 1st of January. Just like on the S3 side, it takes you about a cycle and a half to get everybody on the same annual renewal cycle, and we haven't gone through that complete cycle yet with the M3 side, with the M3 customer base, so at this point, we had only billed approximately \$60 million and collected \$45 of that \$60, so we're converting the rest of the customer base to that January 1st renewal base on the M3 side.

Now, on the S3 side, so as Rob mentioned in his comments, renewal is effectively due at the end of this quarter, in order for customers to remain current. We sent them the invoices at the beginning of March to give everybody plenty of warning and heads up and so that they could make sure that the invoices were acknowledged and in their system and that if there were any questions or discussions that needed to be held, we could have those with plenty of time, and it's our goal to collect everything. Will we collect absolutely everything? That's maybe a little bit optimistic but my view is that listen, just like a phone company, when your maintenance is due by a certain date, you're supposed to pay it on that date. You're not supposed to pay it a month after that date. So we're going through an education exercise and that wasn't always the case so we billed approximately \$175 million of maintenance in early March. We're starting to collect it already. We've made good progress, and I guess we'll tell you at the end of the quarter how we did.

Peter Goldmacher - Cowen & Co. - Analyst

Okay that's great. Very helpful. Thanks, Harry, just one last quick question. I think the Street is going to be a little bit disappointed that licensed bookings were \$31 million when guidance had been for \$32 to \$38 and I don't think you're going to get credit for delivering \$26.4 versus the \$20 to \$25 you had guided on the income statement, although I'll give you credit not that that matters. Is there, was it simply just a timing and mix issue, why those numbers came in a little bit off or is there something else that I'm missing?

Harry Debes - Lawson Software, Inc. - President, CEO

I would tell you that it's difficult as we've demonstrated all year, it's difficult to be accurate and to predict that. It's not a one way street. It's not just us. There is a customer and the customer, the CEO or CFO has a Board to account to, and I'm not making any

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excuses here, but it's just difficult to predict it. I would tell you that we have increased contracting every single quarter since the combination, so we are making progress and we would obviously like to make more progress there.

Peter Goldmacher - Cowen & Co. - Analyst

I'm sorry, I didn't make myself clear. Was the \$31 million a result of you not deferring more in a new licensed deal than you had thought you would or was it just that bookings were just a touch weak and a little bit more came off the balance sheet than you thought?

Harry Debes - Lawson Software, Inc. - President, CEO

Yes.

Rob Schriesheim - Lawson Software, Inc. - CFO

On that Peter, the bookings or contracting as we call it doesn't have anything to do with deferral rate. That's a completely separate and distinct issue. That relates to what we actually recognize on the income statement. The fact the contracting came in at \$31 million as opposed to our range of \$32 to \$38 million is consistent with the issue that I've always highlighted and Harry has highlighted and that is that as we build the global sales organization, as we educate the European salesforce on U.S. GAAP, as we put in place standardized and consistent practices that are uniform and practiced across all geographic regions, we're dealing with volatility.

Peter Goldmacher - Cowen & Co. - Analyst

Right.

Rob Schriesheim - Lawson Software, Inc. - CFO

On a near term basis and so just because we come in excessively high in one quarter on contracting or excessively low one quarter, or we come in marginally high or marginally low, you can't really deduce a lot about that, and so it just is what it is at this point, the contracting. But as Harry says, we have clearly sequentially increased the contracting each quarter since the merger.

Peter Goldmacher - Cowen & Co. - Analyst

Okay, got it. Thank you.

Rob Schriesheim - Lawson Software, Inc. - CFO

Sure thing.

Operator

Our next question comes from Alan Cooke of Merrill Lynch.

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Alan Cooke - Merrill Lynch - Analyst

Hi, Harry, hi, Rob.

Harry Debes - Lawson Software, Inc. - President, CEO

Hi.

Alan Cooke - Merrill Lynch - Analyst

Could you quantify a little bit more about the upside to your Q3 license revenues versus your guidance, specifically, how much of the recognition or how much of the revenues were due to the recognition of Q1 and Q2 deferred revenues?

Rob Schriesheim - Lawson Software, Inc. - CFO

About \$6 million.

Alan Cooke - Merrill Lynch - Analyst

Okay.

Rob Schriesheim - Lawson Software, Inc. - CFO

That's about the amount that flowed in off of the deferred.

Alan Cooke - Merrill Lynch - Analyst

Okay, great. And in your Q4 guidance of the \$24 to \$28 million, how much of that do you expect to be from recognition of deferred revenues from Q1 through Q3?

Rob Schriesheim - Lawson Software, Inc. - CFO

About in the same neighborhood.

Alan Cooke - Merrill Lynch - Analyst

Okay. And then with regards to the maintenance renewal rates specifically for Europe, can you talk about what that rate was and how it compared to past renewal rates, past renewal rates?

Harry Debes - Lawson Software, Inc. - President, CEO

The renewal rates on the M3 side was in the high 80s. That compares to the mid 90s for the S3 side. When we annualized, obviously we're disappointed when it's in the high 80s, however that was made up by some of the very small customers, so we lost some of the very small customers in terms of, who were paying us a low amount of maintenance and so that wasn't a huge, I mean, I don't like losing any customers frankly and so it's disappointing that we didn't have higher renewal rates but that's where it was; however from a revenue perspective, we actually made that up with price increases and new service offerings

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and also additional signings, so from a revenue perspective, we're moving in the right direction. From a renewal rate, it's disappointing when you have, to me it's a crushing blow when we lose one customer frankly.

Alan Cooke - Merrill Lynch - Analyst

Sure, that's very helpful. And then my last question is on the tax rate you improved considerably in Q3. Why was that and also, it did improve for Q4, but I was a little surprised it didn't improve a little bit more. Can you talk about that, please?

Rob Schriesheim - Lawson Software, Inc. - CFO

Yes. This is, as I've -- everyone is looking at me because it's my least favorite topic to try and explain because it's not a sound bite answer, but at the beginning of the year, the Company made an estimate that their effective annual tax rate would be 45%, and then in the first quarter, the effective annual tax rate that was used was 45%. In the second quarter if you recall, the Company made a determination based upon the information available to it at the time and the complicated algorithms they go through to determine the effective tax rate that the annual effective tax rate would not be 45% but would be 58% and as a result, the Company needed to use a rate of 67% in the second quarter to catch up from the 45% that was used in the first quarter in order to bring it to an overall 58% which was the rate that the Company thought that they would be at for the overall year.

Now, as we've gone through the third quarter and profitability has improved in the international operations to some degree, based upon the latest allocation, the Company's made a determination that the annual rate will not be 58% but will be more along the lines of 51%. As a result, in order to bring the overall rate into alignment with the 51%, our Q3 rate was then lowered to 37% to make up for the fact that through the first two quarters, we were at 58%, and therefore, for the fourth quarter we are now in a line with 51% since that is where we think we're going to be for the full year and so for the fourth quarter, we are suggesting that you use 51% for your modeling purposes.

Alan Cooke - Merrill Lynch - Analyst

Okay, that's great. That's very clear. Thank you very much.

Operator

Our next question comes from Adam Holt of JPMorgan.

Adam Holt - JPMorgan - Analyst

Hello, everybody.

Harry Debes - Lawson Software, Inc. - President, CEO

Hi, Adam.

Adam Holt - JPMorgan - Analyst

My questions are actually around the maintenance outlook for the fourth quarter. I just had a first a question, a clarification. If we were to make the pro forma adjustments to the maintenance guidance for the fourth quarter just to be clear, what would you expect to see that maintenance number look like for Q4?

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Rob Schriesheim - Lawson Software, Inc. - CFO

That is -- the number that I gave of \$74 to \$75 million is pro forma.

Barbara Doyle - Lawson Software, Inc. - Vice President Investor Relations

And right now there's only about \$1 million in Q4 that we're expecting, Adam, adjustment wise.

Adam Holt - JPMorgan - Analyst

And just looking at sort of the license trends in the last couple quarters as well as the amount of renewal activity that you have coming up that we've been talking about, why wouldn't that number increase sequentially into the fourth quarter?

Barbara Doyle - Lawson Software, Inc. - Vice President Investor Relations

Well, it is increasing, we are planning up to about \$1 million of an increase but remember, it's, you only recognize three months of a renewal contract in the quarter, so really what we're looking for is probably a lot higher deferred revenue impact than you'll see in any given quarter. On a quarterly revenue basis we're going to see a pretty healthy steady increase. We won't see huge increases.

Adam Holt - JPMorgan - Analyst

But there's no change in expectations around renewal rates or pricing or attach or with the upcoming large renewal period?

Rob Schriesheim - Lawson Software, Inc. - CFO

No, no, none whatsoever. As a matter of fact we remained very confident in saying about the renewal rates that we've experienced in the S3 which have been historically in the 93%, 94%, 95% range and we don't expect to see anything different than that.

Adam Holt - JPMorgan - Analyst

And just if I could shift gears to the Foundation 9 trajectory, it looks like you had a good quarter in terms of starting to get some traction with 135 customers. I was hoping maybe you could give either anecdotally or numerically what you're seeing in terms of licensing activity around that upgrade path and from a module and a revenue perspective.

Rob Schriesheim - Lawson Software, Inc. - CFO

Well, it varies by client, but I would tell you because it depends on processors and a couple of other things, but it's approximately \$25,000 per customer, depending on their needs and the number of servers that are involved it could be as high as \$100,000 for clients. So that's kind of the average price point. Is that what you're looking for?

Adam Holt - JPMorgan - Analyst

But you're also seeing I guess I'm thinking more about in addition to that price point, whether it's serving as a catalyst for footprint expansion?

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Harry Debes - Lawson Software, Inc. - President, CEO

Not necessarily, Adam. We're separating the applications from the technology. That was an important conscious decision that we made because it lowers the total cost of ownership for our clients. It allows them first of all to get to SOA, it gives them additional security capability, and performance improvement, significant performance improvement as we found out, and we do see a few additions in the case of Lawson Business Intelligence, so that's the plug-in module that many customers buy simultaneously, but the important thing about LSF in particular is that we allowed them to upgrade their technology independent of their applications because the application upgrade is typically a larger, more complicated exercise, and we didn't want to have a customer stay behind technically because they perhaps wanted to stay where they are for awhile or they hadn't budgeted it or they weren't ready for an applications upgrade. So it's important to understand the distinction here. LSF and the applications are in fact different and now that we've made that same announcement on the M3 side and by the way that just -- that announcement just happened, we expect to have similar success the next year in selling the M3 clients the LSF version for M3.

Adam Holt - JPMorgan - Analyst

Terrific. Thanks very much.

Harry Debes - Lawson Software, Inc. - President, CEO

Okay.

Operator

Your last question is going to be coming from Brad Smith of Dougherty.

Brad Smith - Dougherty - Analyst

Good afternoon, guys, how are you doing?

Harry Debes - Lawson Software, Inc. - President, CEO

Good.

Brad Smith - Dougherty - Analyst

Just a couple of questions on the sales execution. It seems like the backlog is improving, the overall model is stabilizing. How do you feel about just overall pipeline visibility at this point?

Harry Debes - Lawson Software, Inc. - President, CEO

I feel very good. We've now got -- we now for the first time have a global salesforce application, salesforce automation application that everybody is on, using the same tools and techniques and forecasting mechanism. It took us a long time to get there and we now have visibility into opportunities by country, by sales stage, and we can do a very very good deep dive. In fact tonight, I'm leaving here and heading to Europe for two weeks to do a business review with each of the country managers over there, but we have at our disposal now a lot of the tools, quite frankly, we didn't have before because in the past, the Intentia organization wasn't consistent about how it managed its sales pipeline and it was difficult to be able to do a proper performance assessment

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of a region, so I feel good about the pipeline but more importantly, about the pipeline growth. I'll just give you one -- and I don't like to talk about pipeline too much, but let me give you one data point that illustrates what I'm talking about and also the potential that we've been talking about in the past. On the M3 side, just the M3 side in the U.S. When the combination happens, Lawson/Intentia combination happens, the M3 pipeline in the U.S. was less than \$10 million. Today, it's larger than \$50 million. So, now I'm not saying, that's not necessarily short-term pipeline. That's total pipeline and by the way, that's building, so I'm very very confident that we will be able to translate that into future revenue.

Brad Smith - *Dougherty - Analyst*

Great. And then just on the execution front. Can you talk about some of the changes you saw in Q3 around close rates compared to last quarter?

Harry Debes - *Lawson Software, Inc. - President, CEO*

They haven't really changed that much.

Brad Smith - *Dougherty - Analyst*

Okay.

Harry Debes - *Lawson Software, Inc. - President, CEO*

I think it would vary. In Q3 in particular I think our teams in Asia and Australia and New Zealand have done a particularly good job of converting and closing the deals. We have two nice significant wins and everyone against SAP and Oracle is great, but we have two particularly large deals, one in Europe and one in the U.S. against both of those competitors and when we win deals of that size, you know that we're dealing with senior people on the other side and they are going to pull up all the stops to try to win that deal and to do crazy and unusual things to try to put us off our game, and our team persevered and so I was very pleased about that and it just shows the potential of when you execute well, when you've targeted the right niches and you educated the customer about our value proposition, that we can win any deal, anywhere.

Brad Smith - *Dougherty - Analyst*

Okay, perfect. Thanks a lot, guys.

Operator

At this time, we have no further questions.

Harry Debes - *Lawson Software, Inc. - President, CEO*

All right then. Well, thank you, very much, for joining the call and we look forward to speaking with you at the end of our next quarter.

Barbara Doyle - *Lawson Software, Inc. - Vice President Investor Relations*

Thanks very much.

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