

**Keynote Systems, Inc
Second Quarter Fiscal 2003 Conference Call
April 22, 2003
2:00 p.m. (PDT)**

Operator:

Good afternoon everyone, and welcome to Keynote's Fiscal Second Quarter 2003, ended March 31, 2003, conference call. Today's call is being recorded.

At this time, I would like to turn the call over to Peter Maloney, VP of Finance for opening remarks and introductions.

Peter:

Thank you. Good afternoon everyone, and welcome to Keynote's fiscal 2003, second quarter ended March 31, 2003, conference call. I am here today with Umang Gupta, Chairman and Chief Executive Officer and John Flavio, Chief Financial Officer. John and Umang will review our accomplishments for the quarter and they will be available to answer questions.

Hopefully, by now you have seen our press release that was distributed over Business Wire and the major wire services. For your convenience, the press release has also been posted on our Web site at www.Keynote.com. You can log onto our web site now and find the audio web cast of this call at the Investor Relations section of our site, and it can also be heard at www.vcall.com and www.streetevents.com. The replay of this call will be available by telephone by dialing (888) 203-1112 the pass code is 545591 or by Web cast at the Investor Relations section of our Web site.

I'd like to remind you that statements made during the course of this call that are not purely historical, are forward-looking statements regarding the company or management's intentions, hopes, beliefs, expectations and strategies for the future. Because such statements deal with future events, they are subject to various risks and uncertainties, and actual results might differ materially from those projected in the forward-looking statements.

Important factors that could cause actual results to differ materially from those in the forward-looking statements are discussed in the company's Annual and Quarterly reports filed with the SEC.

Now, I would like to introduce John Flavio, Chief Financial Officer of Keynote.

John:

Thanks Peter. I want to thank you for joining us today as we report results for the second quarter of our fiscal year 2003 which ended March 31, 2003. As a reminder, beginning last quarter we no longer report a pro forma condensed consolidated statement of operations.

The US Generally Accepted Accounting Principles (GAAP) net loss for the second quarter was \$2.1 million, or \$0.09 per share, compared to a net loss of \$2.0 million, or \$0.08 per share, for the preceding quarter, and a net loss of \$3.0 million, or \$0.11 per share for the corresponding quarter a year ago.

On a GAAP basis, the operating loss, which excludes interest income, amounted to \$3.8 million, but declined by nearly \$400,000 from the previous quarter and nearly \$2.1 million from the same comparable quarter a year ago. These reductions occurred despite the fact that this quarter's results included \$424,000 of costs for the amortization of intangible assets and stock based compensation, \$233,000 of proxy contest costs and \$112,000 of severance costs. Excluding these expenses for the amortization of intangible assets and stock based compensation, proxy contest and severance, the loss from operations for the March 31, 2003 quarter compared to the corresponding quarter a year ago was reduced by over \$2.5 million or 46% and compared to the preceding quarter, the loss from operations was reduced by approximately \$749,000 or 20% due primarily to reductions in our operating expenses. The loss from operations excluding the expenses for amortization of intangible assets and stock based compensation, proxy contest and severance is an important measure for investors as it demonstrates our progress in reducing controllable expenses.

In summary, our overall operating results continued to improve both sequentially and year over year, as we make progress toward our goal of profitability (excluding amortization costs) in the quarter ending September 30, 2003.

Total revenue decreased slightly (2%) from the December quarter, yet increased 4% from the corresponding quarter a year ago.

Subscription services decreased by \$274,000 compared to the prior quarter and remained flat compared to the corresponding quarter a year ago.

First I will provide more details on revenue, customers and measurement pages and then I will take a more detailed look at our statement of operations and balance sheet. I will conclude with our expectations for the June quarter, prior to turning the call over to Umang.

Revenues

Our revenue is composed of subscription and consulting and support services revenue. Our total revenue for the March quarter was \$9.6

million, representing a 2% decrease from the December quarter's \$9.8 million and a 4% increase from the comparable quarter a year ago of \$9.2 million.

Subscription revenue amounted to \$8.6 million for the March quarter, which was a \$274,000 or 3% decrease from the December quarter. A good portion of this reduction was due to consolidation of accounts, in particular, because two of our customers merged. Consulting and support service revenue increased 8% sequentially at \$991,000.

Testing and APM

Overall, our testing/APM revenue continued to grow, but at a lesser rate than it had in the previous quarters. This quarter it increased sequentially approximately 3%, compared to the December quarter's 6% increase. A substantial portion of the increase in Testing/APM occurred as a result of the increase in our wireless and WebEffective products offset by a slight decline in revenue from testing engagements and our Red Alert product. Testing/APM revenues amount to 34% of total revenue this quarter, up from 33% last quarter.

As you will recall a year ago, revenue from benchmarking amounted to 78% of our total revenue, but now it accounts for 66% of total revenue. Over that period of time, total revenue has increased somewhat and this change in product mix has occurred as a result of products and services that were newly developed internally or acquired over the last few years.

Customers

Our customer base increased by 22, and amounted to approximately 2,300 companies as of March 31, 2003. As a result, our monthly customer retention rate was an average of 99% for the quarter, which was slightly higher than last quarter's 98%, and consistent with our historical rate of 95% or better.

The number of customers that purchased on an annualized basis at least \$100,000 or more of our services increased to 65, compared to last quarter's 64, and, the proportion of revenue from customers that purchased \$100,000 per year or more increased to 56% of total revenue for the March quarter compared to 52% for the previous

quarter primarily due to increased consulting and WebEffective engagements.

As of the end of March 2003, 74% of the most recent comScore Media Metrix Top 50 Web Sites and over half of the Fortune 100 companies were Keynote customers.

Measurement Pages

At the end of March 2003, we measured for revenue 7,771 page measurements, or URLs, compared to 7,650 at the end of December 2002, a 2% increase. Overall, subscription revenue decreased. The decrease in our URL based subscription services were due mainly to customer consolidations of their accounts, and some decreases experienced in our non-URL based subscription services such as Red Alert and APM. The decrease was slightly offset by increases in our Wireless and Test Perspective products. Overall, average benchmarking revenue per URL for the quarter was consistent with last quarter's at \$289 per month.

Consulting Revenues / Support Services Revenues

Let's move to consulting and support service revenues, which amounted to \$991,000 or 10% of total revenue, which is an 8% increase from the December quarter, and a 52% increase over the March quarter in the prior year. The change in the quarter was generally due to increased revenue in our WebEffective consulting, support services and APM consulting.

Operating Expenses

Total operating expenses for the March 2003 quarter declined nearly \$600,000 from the prior quarter and over \$1.7 million for the same quarter a year ago. This decline occurred despite the fact that this quarter included \$233,000 of costs related to the successful proxy contest and \$112,000 related to severance costs. You will note that this quarter we have captured the excess facility costs all on one line and they amount to \$293,000 compared to \$285,000 last quarter. These are fixed costs of operating our headquarters facility related to unoccupied space.

If you were to exclude from operating expenses the amortization of intangible assets and stock based compensation, proxy contest and severance related costs, operating expenses would have declined to \$12.6 million in the March quarter as compared to \$13.5 million for the December quarter, a 7% reduction, and from \$14.7million or a 15% reduction from the comparable quarter a year ago. Operating expenses excluding the expenses for amortization of intangible assets and stock based compensation, proxy contest and severance is an important measure for investors as it demonstrates our progress in reducing controllable expenses.

In the current quarter, overall costs of subscription and consulting and support services were \$3.2 million or 34% of revenue, which decreased by \$149,000 or 4% over last quarter. The costs of subscription services decreased by \$221,000 or 9% this quarter, as we continue to find ways to reduce the cost of our bandwidth. The decrease was also attributable to lower depreciation and hardware expenses as a result of lower capital investments. Costs of consulting and support services increased by \$72,000 or 8% in the March quarter, primarily driven from an increase in the number of

engagements, in the current quarter. We continued to maintain profitability in the consulting and support services sector and the net margin remained flat quarter to quarter.

At the end of March 2003, we had approximately 1,700 measurement computers, the same number as of the end of December, connected to major Internet backbones in 120 statistically selected locations in 57 metropolitan areas worldwide. These statistics have remained fairly consistent over the last few quarters and we do not anticipate further significant capital investment.

Research and Development

Research and development costs decreased to \$2.1 million for the March quarter or 21% of revenue, compared to \$2.2 million for the December quarter, or 22% of revenue, and \$2.2 million or 24% of revenue for the same quarter in fiscal 2002.

Sales and Marketing

Sales and marketing expenses were down approximately 9% over last quarter and totaled approximately \$4.0 million or 42% of revenue,

as compared to \$4.4 million or 46% of revenue for the December quarter, and \$5.0 million or 54% of revenue for the same quarter in fiscal 2002.

Operations

Operations costs decreased slightly from last quarter. Operations expenses include costs related to our network operations and tech support center. These costs were \$1.7 million (\$1.688) or 18% of revenue for the current quarter, essentially flat from the December quarter [\$1.718 million or 18% of rev]. Operations expenses were \$2.0 million or 21% for the same quarter in fiscal 2002.

General And Administrative Expenses

Our general and administrative expenses increased by \$108,000 over last quarter. These expenses were \$1.6 million or 17% of revenue for the March quarter and \$1.5 million or 15% of revenue for the December quarter. G&A costs were \$1.8 million or 19% of revenue for the same quarter in fiscal 2002. Included in the general and administrative expenses for this quarter was \$233,000 for expenses associated with our successful proxy contest. Excluding these

particular expenses, general and administrative expenses would have declined to \$1.4 million or an 8% reduction compared to the prior quarter and about 22% reduction from the same quarter a year ago. General and administrative expenses excluding proxy contest expenses is an important measure for investors as it demonstrates our progress in reducing controllable general and administrative expenses.

Excess Occupancy Costs

Excess occupancy costs are costs related to fixed charges associated with the unleased portion of our headquarters building. Excess occupancy cost for the quarter was \$293,000 and \$285,000 for the prior quarter. There were no excess occupancy costs in prior year due to the fact that we established an excess facility accrual.

Amortization

Total amortization amounted to \$424,000 for the quarter. Of this amount, \$3,000 was related to the amortization of stock based compensation, which was less than the \$23,000 from previous

quarter. The remaining \$421,000 of amortization expense related to identifiable intangible assets.

Provision for income Taxes

We did not record an income tax provision this quarter due to our operating loss, net operating loss carryforwards, and tax credits.

Shares Outstanding

For the quarter ended March 31, 2003, the total basic and diluted shares were approximately 22.8 million shares of common stock.

During the quarter, we repurchased approximately 364,000 shares of stock on the open market at an average price of approximately \$8.40 per share. Since inception of the repurchase program, the company has repurchased approximately 6.1 million shares and spent over \$48.7 million dollars including fees or roughly \$7.88 per share.

Balance Sheet

Now moving to the balance sheet, at March 31, 2003, our cash balance of \$199 million is composed of cash and short-term investments compared to \$203 million last quarter on a comparable

basis. The majority of the \$4 million reduction in cash was related to the costs of repurchasing our outstanding common stock and capital expenditures. The use of cash was offset by \$900,000 received from employees for stock option exercises and Employee Stock Purchase Plan purchases. We generated approximately \$1.7 million of cash from operations. During the second quarter, we invested \$800,000 in capital, and generated approximately \$900,000 of free cash flow, defined as cash flow from operations less capital investments.

Accounts receivable, net, at March 31st was \$4.1 million, as compared to \$5.4 million in the prior quarter. DSOs were 39 days at the end of the quarter, a decrease from last quarter's 50 days. This improvement in DSO was attributable to improved collections. The aging also improved from last quarters adjusted balance of 11% over 90 days old to 7%.

As of March 31st, our total number of employees is 184.

Guidance

Before I turn the call over to Umang, I would like to provide some general financial guidance for the June quarter. We have provided

detailed guidance in our earnings release today, consistent with the prior quarters. We will not comment on this guidance during the quarter and may provide an update to this guidance in the event of material changes during the quarter. We expect total revenues to be \$9.2 to \$9.6 million for the June quarter ending June 30, 2003. We expect costs of subscriptions to represent approximately 25% to 30% of subscription revenues for the June quarter. We expect costs of consulting and support services to represent approximately 90% to 95% of consulting revenue for the June quarter. Total expenses for research and development, sales and marketing, operations, general and administrative, and excess occupancy costs are currently expected to decrease by approximately 15% compared to the March 2003 quarter. The amortization of the remaining intangibles combined with stock-based compensation will amount to approximately \$430,000 in the June quarter, absent any additional acquisitions or other extraordinary transactions.

We expect interest income, net, to be approximately \$800,000 for the June quarter, assuming we repurchase all 7.5 million shares in our pending tender offer, absent any significant transactions, and

assuming no material changes in interest rates. We would expect weighted average common shares outstanding for the June quarter to decrease to approximately 17.7 million shares, assuming we repurchase 7.5 million shares in our pending tender offer, no additional acquisitions using shares of our stock as the consideration, and no other significant transactions involving our equity securities. Capital expenditures are expected to be approximately \$600,000 for the June quarter, absent any acquisition costs or other extraordinary transactions. Due to the expected loss, loss carryforwards and tax credits, no tax provision is expected in the June quarter.

I would like to now introduce Umang Gupta, our Chairman of the Board and Chief Executive Officer for a business update.

Umang:

Thanks John. Welcome everyone and thank you for joining us today to discuss our second quarter results.

INTRODUCTION AND OVERVIEW

I am pleased with our second quarter performance against a continued challenging economic and political environment. Our dual focus on continued growth in our APM and testing business, while reducing expenses, has resulted in our fifth consecutive quarter of positive cash flow from operations, and free cash flow of approximately \$900,000 for this last quarter.

We are implementing the changes required for us to achieve our goal of profitability, excluding intangibles amortization, in our fiscal fourth quarter, and assuming no growth in revenue. We also anticipate continuing to generate positive free cash flow in the coming quarters of this fiscal year.

Our application performance management and testing businesses continued to grow and increased to 34% of total revenue from 33% the preceding quarter, and 22% the corresponding quarter a year ago.

Keynote's unique value proposition to optimize the customer experience through cost-effective outsourced services is a strong one given the hundreds of millions of dollars misspent on shelfware and unfulfilled IT initiatives and projects. This fact, coupled with increased emphasis on customer satisfaction, at the top of nearly any list related to business and IT requirements, and application quality, puts Keynote in a strong position when the economy itself begins to grow.

Keynote's growing portfolio of Web performance monitoring, management and testing services; which now includes load testing, content testing and user experience testing, not only helps e-businesses wring full value from their current infrastructure, but grow their business as well. The 'return to growth' message is one that is just beginning to resonate in the marketplace and is one that Keynote will capitalize on.

BENCHMARKING

During the quarter, we announced the availability of eight new vertical market Web performance indices, including banking, computers, health care, home loans and mortgages, home specialty (home and office retail), hotel and travel, pharmaceuticals and retail.

These indices provide industry-specific competitive intelligence, and allow site operators to compare, contrast and improve their performance relative to others in their industry.

During the quarter, we also announced that Recreational Equipment Incorporated (REI) expanded their use of Keynote services to include Web Site Perspective and Transaction Perspective, to ensure Web site performance and availability to its customers. REI equates site performance and stability with successful e-business, and directly attributes a great deal of the recognition it has achieved over the past six years as a very successful e-business to its use of Keynote services.

New benchmarking customers for the second quarter include Bell Canada; Concept Technologies; Covansys Corporation; DIRECTV; Internet Pictures Corporation; j2 Global Communications, Inc.; PUMA AG; and Univision Communications Inc.

TESTING & APPLICATION PERFORMANCE MANAGEMENT

Now let's talk about the testing and APM side of our business. As I stated earlier, 34% of the quarter's revenue are from the testing and APM businesses.

During the quarter we announced that FOXSports.com turned to Keynote LoadPro and Test Perspective testing services to assure the performance, reliability and capacity of its Web site for both routine and last minute events, including such major sporting events as the Super Bowl and the World Series.

We also announced that Eastern Bank, the largest full-service independent bank in New England turned to Keynote to provide end-to-end Web site monitoring services and chose Keynote's Red Alert transaction and accessibility monitoring services to assure performance across a wide variety of applications, networks and users.

Additionally, during the second quarter, we announced that the Information Technology Division at North Carolina State University is utilizing Keynote Perspective service and a Keynote private agent both internally and externally on the Internet to improve and maintain the guaranteed service level of its customers.

New Testing and APM customers for the second quarter include Amadeus, Canadian Tire, Fair Isaac, Gateway, German Wings, iPix, J.P. Morgan Chase, Kraft, Nokia, Terra Lycos, United Health Care and the United States Postal Service.

ACQUISITIONS

We continue to focus on identifying good acquisition targets and given the tough economic climate we are seeing some attractive opportunities, although we currently do not have any agreements or commitments to make any material acquisitions. Consistent with our past practices, we employ stringent criteria for selecting the companies that we buy. The company must have innovative technologies in our space, it must have a service or software appliance business model, and the acquisition must be capable of being accretive within 3 to 12 months.

A significant portion of our APM and testing success can be attributed to product lines originated from the six acquisitions that we have completed during the past 2-½ years. I am pleased to report that all of these acquisitions will become accretive by our third quarter of the current fiscal year.

PARTNERS

Partners continue to be an important component of our business strategy.

During the second quarter, we hosted a seminar on e-business user experience with OpinionLab, a leader in online user-feedback systems. The seminar highlighted ways in which e-business can drive effectiveness by measuring and optimizing the user experience, as well as, strategies to improve visitors' online experiences, increase customer satisfaction and e-business revenue, and lower costs.

Additionally, in just a few days, we will host a joint Webinar with EDS. As you know, EDS is now reselling our testing services. Our joint Webinar will demonstrate how to achieve 100% Web site availability by combining Keynote's LoadPro and Test Perspective with EDS' new 100% uptime service level agreements guarantee for its Web Hosting services.

And just yesterday we announced that Cable & Wireless would resell our performance monitoring, management and testing services.

PUBLIC SERVICES

Reenforcing our reputation as the Internet Performance Authority, during the quarter we provided public service reporting on major world and media events, and we launched a Keynote-hosted

user forum devoted to performance management targeted at customers and prospects.

During the quarter, we reported that several Super Bowl advertisers experienced significant site performance degradation during high traffic load generated by their high visibility Super Bowl ads.

Additionally, we reported on the worldwide slowdown in Internet traffic and increase in unavailable Web sites following the release of the MS-SQL Worm on January 25th.

With Americans and much of the world relying on the Internet as a vital communications link, we issued regular "Iraq War Internet Performance Reports" throughout the on-going war campaign against Iraq, that provided data and analysis regarding the performance of major Internet backbones and important government, commercial, media and anti-war Web sites. Our reports were picked up in hundred of news stories with Keynote data and analysis included in stories in The New York Times, The Wall Street Journal Online, Forbes.com and USA Today.

And just last week we monitored Web performance of the most commonly visited sites associated with income tax submission or tax-related information.

CONCLUSION

In closing, we are pleased with our second quarter's performance that was achieved in spite of the economic and political challenges. We are encouraged by the record revenue recorded in the second quarter for our combined Testing and APM businesses, our successful cost reduction initiatives and our fifth consecutive quarter of generating positive cash flow from operations.

We continue to focus on finding new sources of revenue both organically and through acquisitions. We are committed to taking the necessary actions to lower our cost structure as we target profitability, excluding intangibles amortization, for our fiscal fourth quarter, and to continue to generate positive free cash flow.

As always, we appreciate our stockholders' interest and are grateful for your support. That concludes today's formal remarks.

John and I would be more than happy to take any questions you have.

Operator:

We will now begin the question and answer portion of the call. To ask a question.....

Q&A

Umang:

Thanks for joining us today. If you have any additional questions, please feel free to contact John or me.

Operator:

That concludes today's conference. Thank you for your participation.

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