

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

**Operator:**

Good afternoon everyone, and welcome to Keynote's Fiscal Third Quarter 2003, ended June 30, 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, third quarter ended June 30, 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](http://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](http://www.vcall.com) and [www.streetevents.com](http://www.streetevents.com). The replay of this call will be available by telephone by dialing (800) 642-1687 the pass code is 1653167 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 third quarter of our fiscal year 2003 which ended June 30, 2003.

The US Generally Accepted Accounting Principles (GAAP) net loss for the third quarter was \$1.3 million, or \$0.06 per share, compared to a net loss of \$2.1 million, or \$0.09 per share, for the preceding quarter, and a net loss of \$2.5 million, or \$0.09 per share for the corresponding quarter a year ago.

On a GAAP basis, the operating loss, which excludes interest income, amounted to \$2.3 million, but declined by nearly \$1.5 million

from the previous quarter and nearly \$3.2 million from the comparable quarter a year ago. The GAAP operating loss for the third quarter of fiscal 2003 included \$413,000 for the amortization of intangible assets and stock-based compensation and \$392,000 for severance costs. The GAAP operating loss for the second quarter of fiscal 2003 included \$424,000 for the amortization of intangible assets and stock-based compensation and \$233,000 for proxy contest costs. The GAAP operating loss for the third quarter of fiscal 2002 included a charge of \$200,000 for in-process research and development and \$397,000 for the amortization of intangible assets and stock-based compensation. Excluding these charges, the loss from operations for the June 30, 2003 quarter compared to the corresponding quarter a year ago was reduced by \$3.4 million or 70% and compared to the preceding quarter, the loss from operations was reduced by approximately \$1.7 million or 53% due primarily to reductions in our operating expenses. The loss from operations excluding amortization of intangible assets and stock based compensation, severance and proxy contest costs, and in-process research and development is an important measure for investors as it demonstrates our progress in reducing operating expenses.

In summary, our overall operating results continued to improve both sequentially and year over year, as we make progress toward our goal of bottom line breakeven GAAP results in the quarter ending September 30, 2003. We will discuss this in more detail when we discuss guidance for the next quarter.

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 September quarter, prior to turning the call over to Umang.

## **Revenue**

Our revenue is composed of subscription and consulting and support services revenue. Our total revenue for the June quarter was \$9.4 million, representing a 1.3% decrease from the March quarter's \$9.6 million and is essentially flat from the comparable quarter a year ago of \$9.5 million.

Subscription revenue amounted to \$8.7 million for the June quarter, which was \$124,000 or a 1.4% increase from the March quarter.

Consulting and support service revenue decreased by \$250,000 or 25% sequentially at \$741,000.

### **Testing and APM**

Overall, our testing/APM revenue declined sequentially approximately 5%, compared to the March quarter's 3% increase. Most of this reduction was related to two engagements that declined in the June quarter compared to the March quarter, but are expected to increase in the September quarter to historical levels. Testing/APM revenue amounted to one-third of total revenue for both quarters.

Revenue from APM and testing has increased year over year to 33% of total revenue from 27%. Sequential increases are not always possible due to the engagement nature of the business.

### **Customers**

Our customer base remained relatively flat at approximately 2,300 companies as of June 30, 2003. As a result, our monthly customer retention rate was an average of 99% for the quarter, which was flat compared to last quarter, and consistent with our historical rate of 95% or better.

Although the number of customers that purchased on an annualized basis at least \$100,000 or more of our services decreased slightly from 65 to 60, the proportion of revenue from customers that purchased \$100,000 per year was fairly consistent at 55% for this quarter compared to 56% for the prior quarter.

As of the end of June 2003, 76% 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 June 2003, we measured for revenue 7,622 page measurements, or URLs, compared to 7,771 at the end of March 2003, a 2% decrease. Overall, average benchmarking revenue per URL for the quarter was \$304 compared to last quarter's average of \$289 per month.

### **Consulting Revenue / Support Services Revenue**

Let's move to consulting and support service revenue, which amounted to \$741,000 or 8% of total revenue, which is a 25% decrease from the March quarter, and a 23% decrease from the June quarter in the prior year. The number of consulting engagements remained relatively constant this quarter compared to last quarter, but the amount of services purchased was generally less and one testing customer reduced the amount of services they purchased this quarter.

## **Operating Expenses**

Total operating expenses for the June 2003 quarter declined nearly \$1.6 million from the prior quarter and over \$3.2 million for the same quarter a year ago.

Excluding from operating expenses the amortization of intangible assets and stock based compensation, severance and proxy contest costs and in-process research and development, operating expenses would have declined to \$10.9 million in the June quarter as compared to \$12.7 million for the March quarter, a 14% reduction, and from \$14.3 million or a 24% reduction from the comparable quarter a year ago. We believe that operating expenses excluding amortization of intangible assets and stock based compensation, severance and proxy contest costs and in-process research and development is an important measure for investors as it demonstrates our sequential reduction in operating expenses.

In the current quarter, overall costs of subscription and consulting and support services were \$2.9 million or 31% of revenue, which decreased by \$313,000 or 10% from last quarter. The costs of

subscription services decreased by \$389,000 or 17% this quarter, as we continue to reduce the cost of 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 \$76,000 or 8% in the June quarter, due to additional outside consulting costs related to the start of an engagement.

At the end of June 2003, we had approximately 1,700 measurement computers, connected to major Internet backbones in 118 statistically selected locations in 58 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 \$1.7 million for the June quarter or 18% of revenue, compared to \$2.1 million for the March quarter, or 21% of revenue, and \$2.3 million or 24% of revenue for the same quarter in fiscal 2002.

### **Sales and Marketing**

Sales and marketing expenses were down approximately 24% over last quarter and totaled approximately \$3.1 million or 33% of revenue, as compared to \$4.0 million or 42% of revenue for the March quarter, and \$4.9 million or 52% 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 or 18% of revenue for the current quarter, essentially flat from the March quarter.

Operations expenses were \$1.8 million or 19% for the same quarter in fiscal 2002.

### **General And Administrative Expenses**

Our general and administrative expenses decreased slightly from last quarter. These expenses were \$1.6 million or 17% of revenue for both the June and March quarter. G&A costs were \$1.8 million or 19% of revenue for the same quarter in fiscal 2002.

### **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 \$284,000 and \$293,000 for the prior quarter. There were no excess occupancy costs in prior year due to the fact that we had established an excess facility accrual.

### **Amortization**

Total amortization amounted to \$413,000 for the quarter. Of this amount, \$3,000 was related to the amortization of stock based compensation, which was flat compared to last quarter. The remaining \$410,000 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 June 30, 2003, the total basic and diluted shares were approximately 20.8 million shares of common stock.

During the quarter, we purchased all of the approximately 4.3 million shares of common stock tendered in our issuer tender offer, which expired on May 16, 2003, at a price of \$9.50 per share. The aggregate purchase price paid was approximately \$40.5 million.

Additionally, we repurchased approximately 2,500 shares of stock on the open market at an average price of approximately \$9.48 per share. Since inception of the repurchase program, the company has repurchased approximately 10.3 million shares and spent approximately \$89.4 million dollars including fees, or roughly \$8.55 per share.

## **Balance Sheet**

Now moving to the balance sheet, at June 30, 2003, our cash balance of \$159.4 million is composed of cash and short-term investments compared to \$199.1 million last quarter on a comparable basis. The majority of the \$39.7 million reduction in cash was related to the costs of repurchasing our outstanding common stock in the

tender offer. The use of cash was offset by \$1.6 million received from employees for stock option exercises. We generated approximately \$1.5 million of cash from operations. During the third quarter, we invested \$62,000 in capital, and generated approximately \$1.5 million of free cash flow, defined as cash flow from operations less capital investments. Free cash flow is an important measure for investors as it reflects the resources available to invest in acquisitions or to repurchase stock.

Accounts receivable, net, at June 30 was \$4.5 million, as compared to \$4.1 million in the prior quarter. DSOs were 43 days at the end of the quarter, an increase from last quarter's 39 days. The aging has improved from last quarter's adjusted balance of 7% over 90 days old to 1%.

As of June 30, our total number of employees was 162.

## **Guidance**

Before I turn the call over to Umang, I would like to provide some general financial guidance for the September 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 to achieve bottom line break even GAAP results in the September quarter assuming no growth in revenue this quarter. Previously, we had indicated that we would achieve bottom line breakeven excluding the effect of the amortization. In terms of detailed guidance, we expect total revenue to be \$9.2 to \$9.6 million for the quarter ending September 30, 2003. We expect costs of subscriptions to represent approximately 21% to 25% of subscription revenue for the September quarter. We expect costs of consulting and support services to represent approximately 120% to 125% of consulting revenue for the September 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 19% compared to the June 2003 quarter. The amortization of the remaining intangibles combined with stock-based compensation will amount to approximately \$400,000 in the September quarter, absent any additional acquisitions or other extraordinary transactions.

We expect interest income, net, to be approximately \$650,000 for the September quarter, absent any significant transactions, and assuming no material changes in interest rates. We would expect weighted average common shares outstanding for the September quarter to decrease to approximately 18.7 million shares, assuming 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 September 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 September quarter.

And now I would like to turn the call over to Umang Gupta, Chairman and Chief Executive Officer.

**Umang:**

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

## **INTRODUCTION AND OVERVIEW**

I am quite pleased with our performance in Q3 as we are now getting very close to GAAP profitability. The real story behind this quarter's numbers has been our continuing relentless focus on achieving operational efficiencies in order to achieve GAAP profitability, but without sacrificing revenue. Over the last 9 months we have reduced headcount from 227 to 162 people, never an easy process, and shaved approximately \$5 million a quarter in our expense run-rate while maintaining quarterly revenue constant between \$9.4M and \$9.7M. This translates into an average of a \$38 million annual run-rate, while cutting expenses by a \$20 million annualized rate. All the while we have managed to increase revenue received from the APM and Testing components of our business, while slowing the reduction of benchmarking revenue.

Our dual focus on growing our APM and testing business, while reducing expenses, has resulted in our sixth consecutive quarter of positive cash flow from operations, and free cash flow of approximately \$1.5 million for this last quarter.

As a result of successfully implementing reductions to our cost structure we made progress in reducing our operating loss last

quarter, and are well on our way to achieving our goal of sustained quarterly profitability. Assuming no growth in revenue, for our fiscal fourth quarter, we currently expect that we will achieve GAAP bottom line break-even results. We also anticipate continuing to generate positive cash flow from operations for the seventh consecutive quarter.

And while we continue to focus on achieving this important milestone in Q4, we have already begun planning for next year to focus on revenue growth once again as the economy hopefully improves and through better sales productivity and additional M&A activity in appropriate.

Let me turn now more directly to our Q3 results.

Highlights include the fact that our application performance management and testing business has grown to one third of total revenue for the quarter.

During the quarter we continued to align operations, sales and support to better serve the needs of our customers and apply resources more effectively to support the growth opportunities for the business.

We have centralized the sales force for our flagship benchmarking, measurement and monitoring services, primarily a telesales operation, entirely to our Plano, Texas division. We also moved the entire tech support operation there as well. These actions will allow us to continue to provide our customers with great service, support and easy access to our flagship subscription-based benchmarking, measurement and monitoring services, while further reducing operating costs.

Additionally, during the quarter our field sales force was further realigned in focus and compensation on the performance management and testing sides of our business.

As discussed in previous calls, Web performance management and testing services offer Keynote the greatest opportunities for sustained revenue growth as the economy slowly improves. During the current period of economic turbulence, enterprise companies have gained greater appreciation for the true cost-efficiencies to be realized from outsourcing non-core competencies.

We believe, as IT budget spending begins to loosen a bit, Keynote will be a beneficiary. Our outsourced services business model, coupled with our ability to deliver critical Web performance

management and testing solutions in a hassle-free and cost-effective way, is in alignment with the current outsourcing trend.

I am also pleased to announce today the acquisition of Streamcheck, a company based in Toronto, Canada. We welcome Streamcheck and its employees into the Keynote fold and look forward to great things from this new division.

Streamcheck is considered the leader in the nascent Web performance streaming services arena, and is a natural extension of our business.

Current Streamcheck customers include the world's largest media companies such as AOL Time Warner and Viacom; the most prominent service providers in the streaming industry such as Akamai, Cable and Wireless, Speedera, Vitalstream and Loudeye; and top 'new media' properties such as Movielink (a joint effort between Hollywood studios MGM, Paramount, Sony Pictures, Universal and Warner Brothers).

Additionally, Streamcheck is the official source of measurement for Microsoft's certification program for Windows Media 9 service providers.

With this acquisition, we believe Keynote now has services that are each considered the “gold standard” in their area for measuring Web page download, transaction, wireless and now streaming performance.

## **BENCHMARKING**

In Keynote’s benchmarking area, we launched two new vertical market Web transaction performance indices, the Consumer E-Commerce Transaction Index, an industry first, and the e-Banking Transaction Index. These indices provide industry-specific competitive intelligence, and allow retailers and banks to translate their most valuable online transactions into bottom-line business impact.

While these two indices are being actively marketed, the results of both will also soon be published and will set new benchmark standards in these two verticals, much in the way Keynote set benchmarks for overall page download performance in the earlier days of the Internet. Now, much more focus and effort is paid within enterprise companies, from a performance standpoint, on being

competitive in their specific industry-area, and these two new transaction indices support that focus.

Additionally, media and analysts are focusing much more these days on overall “application quality.” Our two new transaction indices for retail and banking put that discussion in much greater focus and also gives Keynote new opportunities to once again demonstrate the value proposition for all its cost-effective and easy to use performance management services.

The two new vertical indices underscore our continued and aggressive sales and marketing efforts to reach financial services and retailing companies with the Keynote value proposition. In fact, we are in the active planning stages for our next Global Internet Performance Conference to be held in New York City on October 27. This event for the first time will have dedicated sessions targeted at the financial services and retail markets.

In addition, during the quarter we announced Total Performance Management for Financial Services and Retail; essentially bundles of our services, which included the new indices, specifically designed to support the Web performance management needs of these verticals.

This is all in addition to a very successful event we staged during the quarter in Manhattan called “Financial Services in a Web World.” We secured speakers from Aetna, JPMorgan, Chase, Pershing and Cable & Wireless to present at the event, which was a sell-out. The moderator was the publisher of Bank Systems & Technology Magazine. We will continue to stage similar-type events focused on bringing the Keynote value proposition to customers and prospects in these two strong customer sectors of our business.

During the quarter we also announced two important new Web performance management services, Transaction Perspective 5.0 and Red Alert Performance Tracker, underscoring both Keynote’s technology and brand leadership. The new services address the evolving needs among enterprise customers in which accurate and representative Web performance measurement, trending and analysis help ensure the quality of service of e-businesses.

Transaction Perspective 5.0 is a new and enhanced version of our leading out-sourced service for Web performance measurement, monitoring, benchmarking, trending and analysis of an enterprise’s most critical or “money path” transactions from the end user perspective. It is an ideal solution for trending and analysis of the true

end-user performance experience and for building industry-appropriate service level agreements with e-business service providers.

Red Alert Performance Tracker is a cost effective, self-service performance monitoring solution for the budget-conscious operational user specifically designed to meet the demanding needs for real time monitoring of a wide variety of Web transactions from multiple geographies, including internationally.

New benchmarking customers for the second quarter include Archipelago, Block Financial Corp, Cupid.com, GMAC RFC, HNS, Jackson National Life Insurance Company, NBA Properties, Inc., and Sonic Solutions.

### **Application Performance Management & Testing**

Let's turn to the APM and Testing side of our business. As I stated earlier, one third of the quarter's revenue came from the APM and Testing side of the business. While we're pleased with our results here, it's important to understand that quarter over quarter revenue may appear "lumpy" as our APM and Testing business is driven quite a bit by a series of customer engagements which don't necessarily

repeat every quarter. Overall, we have been pleased with the trend year to year, which has been quite good.

During the third quarter, we announced WebEffective 3.1, a new version of our usability testing service that includes streamlined reporting and analysis for better understanding why users behave the way they do on Web sites. Additionally, we now have a WebEffective data collection center operating in Paris making the WebEffective service available to customers based in Europe.

We also announced our Best Practices for Total Performance Management (TPM) for E-Government that consists of two new solution-sets targeted at operations, application development and testing personnel within federal, state and local government agencies.

In addition, we also announced WebIntegrity 2.1, a new version of our content integrity testing service that now includes full support for Section 508 compliance testing that sets standards for Web site accessibility for the disabled.

New APM and Testing customers for the third quarter include Accenture, Boston Globe, British Open Golf, Deloitte and Touche,

Extensis, GE Mortgage, Infospace, KB Kids, Macromedia, Orbitz, Summit Bank, Time, Inc., United Cargo, and Williams Sonoma.

## **PUBLIC SERVICES**

We continued to re-enforce our reputation during the quarter as the Internet Performance Authority, by providing public service reporting to the media on important Web events including the Iraq war, the performance of online tax sites leading up to the April 15 deadline, and most recently on the federal government's launch of the DoNotCall Web site and the July 4 Web Site Defacement Challenge.

## **CONCLUSION**

In closing, we are pleased with our third quarter's performance that was achieved in spite of a still struggling economy. We are encouraged by the fact that our combined APM and Testing business represented fully one third of total revenue for the quarter and that our successful cost reduction initiatives resulted in our sixth consecutive quarter of positive cash flow from operations.

We continue to focus on finding new sources of revenue both organically and through acquisitions and to taking continued cost-cutting actions as necessary as we target bottom line break-even GAAP for our fiscal fourth quarter. We also anticipate generating positive cash flow for the seventh consecutive quarter upcoming in September.

As always, we appreciate our stockholders' interest and are grateful for your support.

Before we take any questions that you may have, I would like to turn things back over to John for some special remarks.

**John:** Thanks, Umang. One final matter of a personal nature is to announce some plans that have been in the works for awhile. I am planning to leave Keynote effective September 30, 2003 to spend more time with my family. I am planning on signing all certifications and the Form 10-K when it is filed in December. I have enjoyed my 4 years at Keynote and believe that I am leaving Keynote in great shape financially, and I have decided that now is the perfect time to take some time off. Our VP of Finance, Peter Maloney, who has been with us for nearly two years, will assume the role of CFO on

October 1, 2003. Peter has done a consistently excellent job in assuming more responsibilities and insuring that processes, procedures and controls are in place. Under his leadership, I am confident that all of the finance and administrative organization will be able to support Keynote in its next stage of growth.

I have been fortunate to have had the opportunity to work with a superb team of people at Keynote, while, at the same time, work for a CEO and with a board that I trust and respect that is focused on creating value for all shareholders. I want to wish everyone at Keynote all the success in the future. And now I would like to turn the call back over to Umang.

**Umang:** 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.

END