

Keynote Systems, Inc
First Quarter Fiscal 2004 Conference Call
January 26, 2003
2:00 p.m. (PDT)

Operator:

Good afternoon everyone, and welcome to Keynote's Fiscal First Quarter 2004, ended December 31, 2003 conference call. Today's call is being recorded.

At this time, I would like to turn the call over to Erin Kasenchak, Investor Relations Analyst, for opening remarks and introductions.

Erin:

Thank you. Good afternoon everyone, and welcome to Keynote's conference call for the fiscal 2004 first quarter ended December 31, 2003. I am here today with Umang Gupta, Chairman and Chief Executive Officer, and Peter Maloney, Chief Financial Officer.

Umang and Peter 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. The replay of this call will be available by telephone by dialing (800) 642-1687 the pass code is 4851979 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 today's press release and in the company's Annual and Quarterly reports filed with the SEC.

We have provided detailed guidance in our earnings release today, as we have in prior quarters. This guidance assumes no additional acquisitions or other significant or extraordinary transactions. We will not comment on this guidance during the quarter but may provide an update to this guidance in the event of material changes during the quarter.

Now, I would like to introduce Peter Maloney, Chief Financial Officer of Keynote.

Peter:

Thanks Erin. Now, I will provide you with some details on our accomplishments for the quarter.

GAAP net income for the first quarter was \$667,000, or \$0.03 per diluted share, compared to net income of \$652,000, or \$0.03 per share, for the preceding quarter, and a net loss of \$2.0 million, or \$0.08 per share for the December quarter a year ago.

Revenue

Our revenue is composed of subscription and consulting and support services revenue. Our total revenue for the December quarter was \$9.7 million, a 2% increase from \$9.5 million in the September quarter and essentially flat compared to the December quarter a year ago.

Subscription vs. Consulting

Subscription revenue was \$8.7 million, or 89% of total revenue for the December quarter, and represented an increase of \$286,000 or 3% from the September quarter. The increase was due to successfully providing services directly to customers in Germany, increases in revenue from our Test Perspective, Wireless, WebIntegrity and Performance Scoreboard services, as well as revenue from our newly introduced Network Perspective service.

Consulting and support services revenue was \$1.1 million, or 11% of total revenue for the December quarter, and represented a decrease of \$77,000 or 7% from the September quarter. The decrease was

due to a slight reduction in the number of load testing and consulting engagements compared to the September quarter.

Measurement Services vs. Management Solutions

Last quarter we began disclosing revenue for our Measurement Services business and our Management Solutions business separately, so that investors may view the progress of these two businesses consistent with how we view them internally.

For the first quarter, our Management Solutions revenue was \$2.7 million, an increase of 2% compared to the September quarter, and 23% compared to the December quarter a year ago. Measurement services revenue increased by 2% compared to the September quarter, and decreased by 7% compared to the December quarter a year ago.

Revenue from the management solutions business represented 27% of total revenue for the first quarter of fiscal 2004, 28% for the

previous quarter, and represented 22% of total revenue for the first quarter of fiscal 2003.

Customers

Our customer count remained relatively flat at approximately 2,200 companies as of December 31, 2003. As a result, our monthly customer retention rate was an average of 99% for the quarter, consistent with our historical rate of 95% or better.

Compared to last quarter, the number of customers that purchased on an annualized basis at least \$100,000 or more of our services was up slightly at 61 representing 58% of total revenue for the December quarter.

As of the end of December 2003, 72% of the most recent comScore Media Metrix Top 50 Web Sites and more than half of the Fortune 100 companies were Keynote customers.

Measurement Pages & Devices

At the end of December 2003, we measured for revenue 7,231 page measurements, or URLs, and 7,897 Internet-connected devices.

Overall, average monthly benchmarking revenue per URL for the quarter was \$294 compared to last quarter's average of \$298.

Operating Expenses

Total operating expenses for the December 2003 quarter increased approximately \$185,000 or 2% from the prior quarter, due primarily to expenses associated with our 2003 Global Internet Performance Conference. Total operating expenses decreased \$4.2 million or 30% compared to the first quarter of last year.

At the end of December 2003, we had approximately 1,600 measurement computers, connected to major Internet backbones in 122 statistically selected locations in 54 metropolitan areas worldwide. These statistics have remained fairly consistent over the last few quarters.

Balance Sheet

Now moving to the balance sheet, at December 31, 2003, our cash and short-term investments balance was \$165.7 million compared to \$160.2 million last quarter. During the first quarter, we generated \$4.3 million of cash from operations including the collection of a receivable from a large customer that represents \$1.2 million of prepaid deferred revenue. During the quarter, we invested \$405,000 in property, plant and equipment, and generated approximately \$3.9 million of free cash flow, defined as cash flow from operations less purchases of property, plant and equipment.

Accounts receivable, net, at December 31 was \$4.7 million, and DSOs were 44 days, an increase from last quarter's 41 days consistent with the increase in deferred revenue of 33% to \$5.8 million. As of December 31, 2003, 96% of accounts receivable were less than 90 days old.

As of December 31, 2003, total outstanding common shares were approximately 19.2 million, and our total number of employees was 167.

Guidance

Before I turn the call over to Umang, I would like to provide some general financial guidance for the March quarter.

- We expect total revenue to be in the range of \$9.4 to \$9.8 million.
- Total expenses are expected to remain approximately constant compared to the December quarter.
- We expect interest income, net, to be approximately \$650,000.
- Our effective income tax rate is expected to be approximately 7.5%.
- We expect diluted weighted average common shares outstanding to be approximately 20.5 million shares.
- We expect diluted earnings per share to be in the range of \$0.01 to \$0.03.
- Cash flow from operations is expected to be in the range of \$1.9 to \$2.4 million.

- Capital expenditures are expected to be approximately \$900,000.

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

Umang:

Thanks Peter. Welcome everyone and thank you for joining us today to discuss our fiscal first quarter results.

Introduction & Overview

I am very pleased with our performance in our first quarter of fiscal 2004 as we executed on our commitment to sustain profitability while growing incrementally.

Our dual focus on growing our performance management solutions business and stabilizing the performance measurement business has resulted in a sequential quarter increase in total revenues, GAAP earnings of \$0.03 per share for the first quarter, our eighth consecutive quarter of positive cash flow from operations, and free cash flow of approximately \$3.9 million for the first quarter.

We are quite optimistic about the new services we announced at the end of October. The new services, all now available, include Application Perspective, Performance Scoreboard, PerformanceTune and Test Perspective for Siebel 7.

To date, customers have been extremely receptive to hearing about what the new services offer and we are already beginning to take orders.

Each one of the new services fills a particular and extremely useful need for enterprise customers. Some of the new services make us more valuable behind-the-firewall. Some of the new offerings make us more valuable outside-the-firewall.

Together, the new services allow us to offer customers comprehensive, end-to-end, operational monitoring and root cause diagnostics for critical e-business application at the lowest total cost of ownership.

And more importantly, the new offerings position us extremely well to serve the needs of large enterprise customers that grapple on a daily basis with the growing need to manage application performance, on both sides of the firewall, efficiently and cost-effectively.

Performance Measurement Services

The most important news this quarter for the performance measurement services business was that revenue did not decrease, in fact it increased slightly.

The focus this quarter in this part of our business was not on announcing new services per se, but on leveraging the breadth of measurement and monitoring services we already provide. So we focused on securing current measurement customers including providing services direct to our German customers that were previously serviced through a reseller that filed for bankruptcy protection, and obtaining new customers including Broadspire, European Space Agency, International Broadcast Bureau, PC World Communications, and Thomas Cook AG.

Performance Management Solutions

Let's turn to the performance management side of our business.

Almost 30% of the quarter's revenue came from performance management solutions compared to 22% for the corresponding

quarter of last year. While we're pleased with our results here, it's important to understand that quarter over quarter revenue may appear "lumpy" as our Enterprise Solutions and Testing businesses are driven quite a bit by a series of customer engagements, which don't necessarily repeat every quarter. Overall, we have been pleased with the both the growth from last quarter and the trend year to year, which has been quite good.

In fact, we continue to believe that the performance management opportunity for Keynote is a large one. A very recent 2003 IT budget survey conducted by Gartner among over 400 Global 2000 companies showed that outsourced application management services represents approximately a \$500 million market.

In the management area we announced Network Perspective, based on our acquisition of Xaffire's deep Internet diagnostic services, the Insight Service suite, originally developed by Matrix NetSystems.

With this acquisition, during the December quarter, Keynote was able to capture an average of over 40 million Internet measurements daily.

This is Keynote's eighth acquisition in three years and we're quite pleased with the efficiency of the acquisition process and the subsequent integration of both Xaffire's technology and personnel into the Keynote fold.

The renamed Xaffire service, now called Network Perspective, offers detailed performance statistics and diagnostics on Internet transit from and between many different ISPs and geographical locations. It is the ideal complement to our Web site performance measurement and diagnostic data.

New Performance Management customers for the first quarter include British Petroleum, Careerbuilder, Dionex, Fujitsu-America, Genuine Parts, Jaguar, Lowe's, Media General, Palm, Rodale Press, SAP AG, Sybase, The Neiman Marcus Group and Thomas Cook AG.

Public Services

In 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. Beginning a few days after Thanksgiving we began reporting to the

media on the performance of the E-Commerce Transaction Performance Index during the holiday shopping season.

As you know, this was one of the Internet's most successful holiday shopping seasons ever and generated intense media interest. We issued five press releases during the shopping season and did dozens of interviews with significant stories citing our data and analysis appearing in leading national and city dailies around the country including The New York Times and The Washington Post. This broad visibility helps us to generate interest among the large retailers in the services Keynote provides.

We have another major Web event underway which will continue through the presidential election in November. We are reporting on the performance of the presidential candidates' Web sites, including their streaming performance. We have already done a number of interviews with the media on this topic including with CNN Headline News and NPR.

And, next week we will be reporting on the performance of the Super Bowl advertiser's Web sites!

Conclusion

In closing, our traditional performance measurement services business has exhibited recent signs of stabilizing, while the performance management portion of our business has grown to close to 30% of total revenue. Our focus on optimizing operational efficiencies and strict expense controls is reflected in our second consecutive quarter of profitability, eighth consecutive quarter of positive cash flow from operations, and the \$3.9 million of free cash flow generated this quarter.

We continue to focus on finding new sources of revenue both organically and through acquisitions, as we target sustained GAAP profitability and positive free cash flow for our fiscal 2004 second quarter. While we do not provide specific guidance beyond the current quarter, currently we believe that even assuming no growth in revenue for the rest of the year we are capable of growing profitability for fiscal year 2004.

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

That concludes today's formal remarks.

Peter 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 Peter or me.

Operator:

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

END