

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

Operator:

Good afternoon everyone, and welcome to Keynote's conference call for the Fiscal Third Quarter 2004, ended June 30, 2004. 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 third quarter ended June 30, 2004. 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 #8472262 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 other than those described in our earnings release. 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 third quarter was \$1.5 million, or \$0.07 per diluted share, compared to GAAP net income of \$1.2 million, or \$0.06 per diluted share, for the preceding quarter, and a GAAP net loss of \$1.3 million, or \$0.06 per share for the June quarter a year ago.

Revenue

Our revenue is composed of subscription and consulting and support services revenue. Our total revenue for the June quarter was \$10.7 million, a 9% increase from the March quarter and a 14% increase compared to the June quarter a year ago.

Subscription vs. Consulting

Subscription revenue was \$9.5 million, or 89% of total revenue for the June quarter, and represented an increase of 8% from the March quarter. The increase was driven by higher revenue from our Transaction Perspective, Streaming Perspective, WebEffective Intelligence Platform and Wireless Perspective services.

Consulting and support services revenue was \$1.2 million, or 11% of total revenue for the June quarter, and represented an increase of 18% from the March quarter, and an increase of 62% compared to the June quarter a year ago.

Measurement Services vs. Management Solutions

For the third quarter, our Management Solutions revenue was \$3.7 million, an increase of 24% compared to the March quarter, and an increase of 68% compared to the June quarter a year ago.

Measurement services revenue increased by 3% compared to the March quarter, and decreased by 3% compared to the June quarter a year ago.

Revenue from the management solutions business represented 34% of total revenue for the third quarter of fiscal 2004, 30% of total revenue for the previous quarter, and represented 23% of total revenue for the third quarter of fiscal 2003.

Customers

Our customer count was over 2,100 companies as of June 30, 2004. Our monthly customer retention rate was an average of 99% for the quarter.

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 at 63, and the percentage of revenue from these customers increased to 63% of total revenue for the third fiscal quarter of 2004.

As of the end of June 2004, 70% of the most recent comScore Media Metrix Top 50 Web Sites and over half of the Fortune 100 companies were Keynote customers.

Measurement Pages & Devices

At the end of June 2004, we measured for revenue 7,822 URLs through our Perspective Services, and 7,641 Internet-connected devices. Overall, average monthly benchmarking revenue per URL for the quarter was \$285.

Operating Expenses

Total operating expenses for the June 2004 quarter increased approximately \$589,000 or 6% from the prior quarter, primarily as a result of our acquisition of NetRaker. Total operating expenses decreased \$1.9 million or 16% compared to the third quarter of last year.

At the end of June 2004, we had over 1,600 measurement computers, connected to major Internet backbones in 124 statistically selected locations in 56 metropolitan areas worldwide.

Balance Sheet

Now moving to the balance sheet, at June 30, 2004, our cash and short-term investments balance was \$169.4 million. During the third quarter, we generated \$3.8 million of cash from operations. During the quarter, we invested \$745,000 in property, plant and equipment, and generated approximately \$3.0 million of free cash flow, defined as cash flow from operations less purchases of property, plant and equipment.

Accounts receivable, net, at June 30 was \$4.7 million, and DSOs were 39 days, as compared to last quarter's 43 days. As of June 30, 2004, 98% of accounts receivable were less than 90 days old.

As of June 30, 2004, total diluted outstanding common shares were approximately 21.1 million, and our total number of employees was 175.

Guidance

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

- We expect total revenue to increase to between \$11.0 to \$11.4 million.
- Total expenses are expected to increase by approximately 8% to 10% compared to the June quarter.
- We expect interest income, to be approximately \$700,000.
- Our effective income tax rate is expected to be approximately 8%.
- We expect diluted weighted average common shares outstanding to be approximately 21.2 million shares.
- We expect diluted earnings per share to be in the range of \$0.04 to \$0.06.
- Cash flow from operations is expected to be in the range of \$2.0 million to \$2.5 million.
- Capital expenditures are expected to be approximately \$1.5 million.

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 third quarter results.

Introduction & Overview

I am very pleased with our performance in the third quarter, as we continue to execute on our commitment to sustain bottom line profitability, while growing top line revenue.

We are proud of our third quarter results, which represented our fourth sequential quarterly increase in total revenue and profitability and our tenth consecutive quarter of positive cash flow from operations.

In addition to the above, I am also pleased that we were able to achieve modest growth in the measurement business, and once again showed good revenue growth on the management side of the business.

On the M&A side, our most recent news was the announcement a few weeks ago of our acquisition of Hudson Williams, a highly skilled and experienced performance management consultancy group based in New York City and a long-standing performance management and testing services partner of Keynote. This is a great acquisition for Keynote and even better for our many customers in the northeast, particularly our many financial services customers based in Manhattan, who needed more local access to the kind of Keynote expertise delivered through Hudson Williams and through our own San Mateo based enterprise solutions group.

Our plan is to fully integrate the Hudson Williams professional services team with the Keynote enterprise solutions, and testing and tuning groups. The combined teams now consists of over 26 technology professionals that delivered over 22% of our revenue for the third fiscal quarter of 2004. This acquisition marks Keynote's tenth acquisition in just four years and we'd like to warmly welcome the employees that have joined us from Hudson Williams into the growing Keynote family.

This quarter we announced the addition of two new outside members to the Keynote board of directors: Raymond L. Ocampo

Jr., retired senior vice president, general counsel and secretary of Oracle Corporation and Jennifer Bolt, senior vice president and chief information officer of Franklin Resources, Inc.

Ray is well known in the industry and brings us tremendous experience in issues related to corporate governance. Jennifer is intimately familiar with the challenges faced by corporate CIOs, and also with the needs of financial investors. Ray and Jennifer bring a depth of real world knowledge about how we can best serve our customers and investors and I am very pleased to welcome both of them to the Keynote board.

On June 8 we held an extremely successful Total Performance Management Symposium in Manhattan attended by over a hundred customers, prospects and partners. In addition to holding a variety of technical and business sessions focused on Web performance measurement and management, senior executives from HP joined Keynote in a live demo of our new Application Perspective for HP OpenView service. Our marketing department is already hard at work planning the next symposium to be held in Washington, D.C. during the fourth quarter. These symposiums are turning out to be excellent vehicles for spreading the Keynote message and generating

prospects for our ever-growing portfolio of performance management services.

Now I'd like to talk in slightly greater detail about the two primary revenue-generating areas of the business: performance measurement and management.

Performance Measurement Services

66% of the quarter's revenue came from performance measurement solutions compared to 77% for the corresponding quarter last year. This represented a 3% increase from the prior quarter, a trend we are quite pleased with. While it would be premature to indicate that this represents a long-term trend, we do believe that the growth occurred due to several factors:

1. Transaction Perspective, our flagship transaction service, showed solid growth this quarter as a result of a special sales and marketing emphasis on emphasizing our industry-specific transaction measurement services. We also saw good growth in our Streaming Perspective service.

2. Application Perspective Outside Edition, our newest and most cost-effective outside-in measurement service, has gained excellent customer acceptance.
3. Red Alert, our monitoring service, showed respectable growth in the small business segment.

Our goal is to continue to drive forward the value proposition for each measurement service in our portfolio in order to meet nearly every price point and need in the market. We are hopeful that the three-year trend of declines in the measurements business is behind us, and that we may, in fact, with the help of a growing economy and of significant increases in Internet usage, once again resume some growth in this important area of our business.

We also broadened the Application Perspective measurement infrastructure by doubling the number of worldwide geographical locations from which customers can measure transaction performance with Application Perspective Outside Edition.

When Application Perspective Outside Edition initially became available in February, transaction monitoring was immediately available from 15 cities. We have added additional cities from which

customers can measure, monitor and diagnose transaction performance from the end user perspective.

The additional North American geographic locations from which customers can monitor transaction performance include: Atlanta, Miami, Seattle, Cleveland, Minneapolis and Toronto. The additional international locations include: Brussels, Helsinki, Madrid, Milan, Oslo, Singapore, Shanghai, Sydney and Tokyo. Our plan is to continue to increase the overall number of locations and agents for Application Perspective Outside Edition.

The reaction of our customers to Application Perspective Outside Edition is best described in a recent quote from a new Keynote customer: The customer commented, “We needed a way to monitor many transactions and receive clear and actionable data. We completed a very thorough evaluation of several vendors, and Keynote stood out in all respects -- data, alerts, pricing and tech support.” End Quote. We believe that Application Perspective Outside Edition delivers the best web performance measurement and monitoring capabilities in the market at the best price, bar none.

New Performance Measurement customers for the third quarter include Autotrader, Inc., Electric Insurance Company, First Midwest Bank, and TruEffect LLC.

Performance Management Solutions

Let's now turn to the performance management side of our business. 34% of the quarter's revenue came from performance management solutions compared to 30% for the prior quarter and 23% for the corresponding quarter of last year. Management solutions revenue increased 24% compared to the prior quarter and 68% from the same quarter a year ago, a trend we are quite pleased with. We are already deriving revenue from our recently available Application Perspective Private Edition service with revenue booked in the quarter for this service from BI, CondeNet, Fair Isaac and StockCharts and we have now begun to jointly market the HP edition of this important Keynote product with the help of the HP sales force.

Additionally, we had an opportunity last month to talk about the new service and demonstrate its capabilities with HP executives at HP's Software Forum, HP's annual user event, in Montreal. The dedicated session entitled, "Comprehensive Web Application

Management With Keynote and HP's Joint Solution," was delivered to an audience of "all HP users" and was very well received.

In Customer Experience Management, we benefited this quarter from our newly acquired NetRaker service that is now part of our comprehensive WebEffective Intelligence Platform. The integration of NetRaker into Keynote has gone smoothly, while the division's executives continued to promote Keynote as experts in customer experience management through high profile speaking events including at the prestigious Computer Human Interaction 2004 Conference in Vienna, San Francisco's Ad: Tech Conference in San Francisco and most recently at Jupiter Media's Internet Planet event in New York City. New WebEffective Intelligence Platform customers secured during the quarter include IBM and Overture.

We continued building on the success of our wireless business unit in the third quarter with close to 100% revenue growth over the same quarter last year and continued quarter over quarter double-digit revenue growth in wireless. During the quarter we completed the deployment of 75 wireless network-monitoring agents as part of a large agreement with a leading wireless provider. We made

significant improvements in the Wireless Perspective portal to better handle the needs of our large wireless carrier customers and continued to execute on our carrier sales strategy in the US and are now making significant progress in our efforts in Europe and Asia where we see great potential for wireless performance management services. Lastly, we released an updated version of the Wireless Perspective service to provide more detailed diagnostic and component data for wireless data network monitoring.

Finally, in our performance management business, we launched WebIntegrity 3.0, a new version of our hosted service that enables enterprises to proactively monitor their Web sites to ensure compliance with privacy, security and corporate standards. The announcement is particularly timely as California AB 68, a new law mandating that all Web sites collecting information from California residents must display a privacy policy and must comply with said policy, took effect on July 1. With WebIntegrity 3.0 we are opening a new front in our drive to increase revenues from the rapidly increasing need for compliance services that help to keep e-businesses in compliance with the law and also with internally mandated content standards.

New Performance Management customers for the third quarter include Agilent Technologies, Autobyte, Barnes and Noble, Best Buy, eHarmony, Expedia, Kaiser, MasterCard, Nordstrom and Western Union.

Public Services

Last quarter was an extremely productive one in Public Services with many significant announcements and events.

In conjunction with our appearance at Streaming Media East in New York, we announced the results of our first annual news video quality study. The annual video study will serve as a benchmark that news sites can use to assess the quality of their Web streams from the end user perspective.

In conjunction with our appearance at the Forrester Finance Forum, also in Manhattan, we announced the new Keynote Performance Awards and the inaugural winners in online banking and trading.

E*TRADE FINANCIAL won both awards for best transaction speed and best transaction reliability in the online trading category. SunTrust Banks won the award for best transaction reliability and

Wells Fargo won the award for best transaction speed in the online banking category.

During the quarter we also announced a new transaction index, our eighth, called The Keynote News Media Web Transaction Index, which measures the transaction speed and reliability of 19 leading news media Web sites.

Our vertical indices are extremely useful marketing and sales tools. They help us show customers and prospects, the benefits of measuring transaction performance from the outside in, and against the competition and their peers in the industry.

Conclusion

In closing, we continue to be pleased with the progress we make each quarter. Our focus on optimizing operational efficiencies is reflected in our fourth consecutive quarter of profitability, tenth consecutive quarter of positive cash flow from operations, and in the \$3.0 million of free cash flow generated this quarter.

We also continue to work on developing new sources of revenue both organically and through acquisitions, as we target sustained profitability and positive free cash flow for our fiscal 2004

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

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.

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