

FINAL TRANSCRIPT

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LWSN - Q1 2009 Lawson Software, Inc. Earnings Conference Call

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Cross Research - Analyst

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PRESENTATION

Operator

Welcome and thank you for standing by. At this time all participants are in a listen only mode. After the presentation we will conduct a question-and-answer session. (Operator Instructions). Today's conference is being recorded. If you have any objections, you may disconnect at this time. I will turn over the meeting over to Miss Barbara Doyle. Miss Doyle, you may begin.

Barbara Doyle - *Lawson Software, Inc. - VP, IR*

Thank you Kelly and good afternoon everyone on the call. Welcome to Lawson Software's fiscal 2009 first quarter conference call covering the quarter ended August 31, 2008. With me on today's call are Harry Debes, Lawson's President and Chief Executive Officer; Rob Schriesheim, Executive Vice President and Chief Financial Officer; and also Stefan Schultz, Senior Vice President of Finance.

Today we will discuss the results for our first fiscal quarter and provide financial guidance for our second fiscal quarter. Then we will open up the call to your questions as the operator described. I will remind you that you can access a copy of our press release at www.Lawsons.com/investor. Now please allow me to review the Safe Harbor Statements.

We would like to remind you that this call will include forward-looking statements which are subject to risks and uncertainties. These forward-looking statements contain statements of intent, belief or current expectations of Lawson Software and its management.

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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 our forward-looking statements. Our SEC filings contain further information about risk factors that could cause actual results to differ from management's expectations.

We do not obligate ourselves to update forward-looking statements for circumstances or events that occur in the future. I would also remind you that in addition to reporting financial results in accordance with generally accepted accounting principles, Lawson Software also reports non-GAAP financial results. Discussion of our use of non-GAAP results as well as a reconciliation of our non-GAAP results to GAAP is included in our press release. With that, let me turn the call over to Harry Debes.

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

Thank you Barbara and good afternoon everyone. I will begin by discussing our first quarter revenues and giving my perspective on our results.

Bob Schriesheim will then cover highlights of our financial performance, focusing more on the bottom half of the income statement, on our cash flows and also to give you guidance. We will then end the call with some closing comments and then we will take your questions.

So let's begin. First, I'd like to address the macroeconomic climate and its impact on our business as this is a question people have been asking for the last ten months. All of last fiscal year, the economy did not impact our ability to find new business.

We achieved or exceeded our license contracting targets in each of Q2, Q3 and Q4. In fact, Q4 was an all-time record for license contracting for the Company. In Q1 of FY '09 which ended in August, there were broad concerns about the financial sector, but from our perspective on the question of software license contract signings, the economy had little impact.

But now with the events in September which are creating a freeze in credit markets, that may well have changed. So far, economic conditions have also not impacted our maintenance revenues which remain strong. However, economic conditions have impacted our services business which has now shown a few quarters of weaker demand.

Now I will go into a bit more detail. Q1 is typically our weakest quarter and this Q1 was no exception to that trend. The reason for the weaknesses is that nearly half of our business comes from Europe and during the months of June, July and August Europeans go on extended holidays.

As a result, major investment decisions are rarely taken during this time of year. And like our customers, our consultants also take their holidays during these months and therefore spend less time on billable customer engagements.

In Q1 we signed \$26.5 million of software contracts, just up slightly from last year. We ended the quarter with 211 sales account executives up from 198 at year end. Sales productivity for AE was flat compared to Q1 of 2008.

License contracting in our health-care vertical exceeded our plans. In the public sector, vertical contracting was very close to plan but we were below target in S3 sales outside of our target verticals, in the M3 US sales area and also in some regions in Europe.

So why did we fall short? While we did notice some weakness in activity late in the quarter, the primary reasons for the miss were as follows.

First, Q4 was the biggest contracting quarter in our history. So our pipeline at the beginning of Q1 was a bit weaker than it should've been. Not in terms of dollar size but in terms of deal quality.

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We did not come to terms with the lack of quality of our Q1 pipeline until halfway through the quarter. We are rebuilding that pipeline now and we are encouraged by those results.

Second, there were six forecasted deals worth approximately \$4 million that slipped because we did not have the right contract language or because we did not obtain the needed customer level sign-off's in time for the quarter close. All but one of these deals has now been signed and we expect to sign that remaining deal shortly. In fact, one of those deals was signed on the first day of the new quarter.

So some of the sloppy execution on our part -- some of this was sloppy execution on our part and some of it is that we can't always control access to customer executives according to our quarter-end timetables. I have been selling software for 30 years and I can tell you that in some quarters deal velocity goes in your favor and you sign absolutely everything, even deals you did not forecast.

But in other quarters, deal velocity does not go exactly as planned and this was one of those times it did not go our way. But let there be no doubt, we are disappointed with these contract signings results and as a result, we're taking a harder look at the deals in our short-term pipeline and making sure that our closing timetables and activities are more crisp and achievable.

We're satisfied that the existing customers and prospects like what Lawson has to offer and that we will improve our license contracting performance. A significant portion of the license contracts signed in Q1 were deferred for revenue recognition in future quarters. In fact, this was the highest deferral revenue level we have had in the last five years.

Last year, our contracting to revenue conversion rate averaged 63% over the four quarters. But in this quarter, it was only 53%. Now this has nothing to do with the economy.

Instead it is determined by deal-specific terms and it is also driven by the fact that Lawson engages in delivering services directly with our software. The the accounting rules on software revenue recognition would reward us with 100% conversion if we gave services revenue away to third parties.

But it's Lawson's value proposition to be a software end services vendor. We offer our customers a total solution which includes software services and maintenance directly from Lawson when appropriate and as long as we continue to do that, a significant portion of our software contracts will be deferred and then recognized as the services are delivered.

A great example is the (inaudible) contract we signed in December 2007. (inaudible) paid us the license fees in March 2008 but as of today, we have not yet recognized \$1.00 dollar of that revenue.

Here's another example. Increasingly we're bundling our software with our premium maintenance and hosted services. Customers want this bundling because it makes their lives simpler.

But every time we do this, the license revenue gets deferred. Last quarter we signed a major deal and bundled it with a five-year hosting contract. The customers pay us for the software, but accounting rules require us to recognize the license revenue over the next five years.

So in some respects, our model is changing from the sell it now and recognize it now model we had in the past to something which is more akin to the SASS model where the revenue is recognized either over the installation cycle or over the term of the hosting arrangement. But this is not all bad news.

Last year at this time, our deferred license revenue balance was \$35 million. At the end of May so at the end of our fourth quarter, it was \$54.6 million and now at the end of Q1 it stands at \$57.8 million.

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Moving this revenue from the balance sheet to the P&L is now accounting timing. We expect to recognize a significant portion of this backlog during this fiscal year. And in some respects, this makes future software license revenue more predictable.

Now I want to give you complete transparency, so let me give you the simple math for the first quarter. We signed \$26.5 million of license contracts in the quarter. 47% of that or \$12.5 million was deferred. We rolled \$7 million from the balance sheet to the P&L and the net result is that we recognized \$21 million in license revenue in the quarter.

Now I will move on to discuss maintenance. Our maintenance business is strong and stable as it has been for some time. More than 65% of our total maintenance revenue for FY '09 has already been collected.

In Q1, maintenance grew by \$10.2 million year-over-year for a 13% increase. It was 47% of total revenue in the quarter and we continue to see strong renewal rates for both our S3 and M3 products and more customers are selecting our premium total care contracts. I'll just remind you that next major renewal period is January 2009.

Now moving to our consulting services business. As we've said in the past, consulting is an important business for Lawson because delivering implementation services directly from Lawson helps us to differentiate from our competition. We've also stated that we are consciously slowing revenue growth because we want to put greater focus on margins.

In the first quarter, our services revenue was lower than forecasted and declined 3% from last year. This shortfall in revenue was due to a combination of lower than planned headcount and also lower than planned Q1 utilization.

As a result, services gross margin in the quarter was 10% compared to 15% same quarter last year. Our execution and performance in the services area was spotty.

We know that our Companywide margin goals of 20% plus can be achieved because we are already achieving margins in excess of 25% in some markets. We have now isolated the underperforming services businesses and are taking the appropriate corrective actions. In fact, I expect that our services business will deliver margins very close to the 20% level in this our second quarter.

So in summary, our overall performance in the first quarter was not as good as it has been in the past or as it could be. I have given you explanations of why we missed certain numbers because you deserve answers.

But we're not in the excuses business. Instead we are establishing a performance cochair at Lawson and when we miss our own guidance no matter what the reason, we must take responsibility for not executing at levels of which we're capable.

Sure, compared to where we were a few years ago, we have raised the bar. Then, (inaudible) operating income in any quarter would have been a victory. Today, even in our weakest quarter, it's a disappointment. But we are all committed to delivering a much better result in our second quarter. Now I will turn the call over to Rob for a deeper dive into our financial performance.

Rob Schriesheim - Lawson Software, Inc. - EVP and CFO

Thanks Harry. Good afternoon everyone. Let me add a few comments to the press release and to Harry's remarks. I will also provide our financial guidance for Q2. I will begin by covering some key financial metrics on performance.

Total revenues of \$191 million increased 2% compared to last year. By geography, Q1 revenues in the Americas were 55% of the total, EMEA was 41% and Asia-Pacific was 4%. Harry has already thoroughly covered revenue so I will speak to Q1 expenses, earnings and cash before I provide our Q2 guidance.

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Q1 non-GAAP earnings of \$0.05 per share was down \$0.02 year-over-year and fell a penny short of our guidance range. EPS declined \$0.03 year-over-year driven by three factors -- a \$3 million decrease in non-GAAP operating income, lower interest rate yields and currency impact. Each of these items drove about \$0.01 of the decline.

On the positive side, the combination of a lower tax rate of 35% versus 37% and fewer shares outstanding resulting from our stock buyback had some positive benefits, adding \$0.005 to EPS when compared to last year. Non-GAAP gross margin was flat year-over-year at 52% despite the 500 basis point decline in services margin that Harry discussed.

Services were the only concern in gross margin. Maintenance margin improved 70 basis points. License margins were relatively flat. The maintenance margin improvement and the higher mix of maintenance revenue to total revenue offset the decrease in services gross margin.

Q1 non-GAAP operating margin of 6.4% was down 180 basis points from 8.2% in Q1 of last year. Non-GAAP operating margin was certainly impacted by lower licenses and services revenues year-over-year. However, I would like to take a few minutes to highlight the benefits and expenses we're seeing from various operating initiatives we executed over the last two years.

Removing impacts from currency fluctuations, total expenses decreased year-over-year. You can see our currency impact schedule in our press release.

On a constant currency basis, non-GAAP operating expenses were held flat year-over-year and total expenses were down 2% year-over-year. This result came despite making some substantial targeted investments in key initiatives.

These included marketing and sales in our targeted verticals, building our R&D and customer support capacity, delivering a new customer management system, investing in our global IT and business system infrastructure and building our offshore capacity. Total Lawson headcount increased by 7% year-over-year driven by aggressive hiring at our Manila facility.

We doubled the size of the team in Manila in one year's time and we now stand at 810 employees at the facility. At the same time, our onshore headcount decreased by 3% year-over-year in total with targeted increases in sales and marketing to support our key verticals, including a 6% increase in the number of sales executives.

G&A headcount and expenses have declined year-over-year resulting from process efficiencies we enacted throughout the last year and from consolidating work in our shared services centers in Switzerland and Manila. Notably, contractor FTE's and expenses were down 65% year-over-year.

As a result, our G&A declined nearly 20% from Q1 of last year from \$25.5 million to \$20 million. We also decreased the total number of services employed in the US and Europe as we balance resources with demand in certain regions and have higher utilization of our team in Manila.

In Q1 '09 11.6% of our billable service hours were delivered by our Manila team compared to 6% in Q1 '08. Total total billable hours delivered from Manila increased by 54% year-over-year to 35,500 hours.

This year we will slow down the pace of hiring new employees in Manila to focus on improving productivity as we have not yet reached the productivity targets we have set. However, this initiative has already enabled us to increase our capacity while holding expenses flat even with more improvements in utilization to be made.

Overall, we've made significant strides in productivity with a lower cost base from last year which is evident in the year-over-year constant currency expense performance. While we certainly judiciously manage expenses on a day-to-day basis, the improvements in our efficiency and cost are primarily a result of the core transformation we've made in our global business processes.

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The savings are permanent and sustainable. These were not minimal our easy changes to make and we've proven that we can substantially transform the business.

Now let's turn to items below the line. A decline in net other income impacted EPS \$0.015 compared to this time last year. Interest income declined by \$3.8 million because of lower investment balance in the quarter and lower yields on those investments.

Our cash and investment balance declined by \$125 million year-over-year driven by \$207 million of cash used for share repurchases in fiscal '08 and Q1 '09. We also have purposely shifted our investments to shorter term and lower yield accounts given the current market conditions. The lower yield on our cash investments resulted in \$0.01 per share in negative impact on our EPS.

Our non-GAAP effective tax rate of 35% improved by 200 basis point year-over-year. We anticipate that 35% will be prudent for modeling purposes.

Regarding share count, diluted weighted average shares were 171.7 million in Q1 for purposes of non-GAAP EPS calculation. This doesn't reflect the full benefit of the accelerated share repurchase as the shares were acquired midway through the quarter.

At the end of August we had 163 million common shares outstanding. A reasonable estimate for Q2 modeling would be 167 million fully diluted weighted average shares.

In Q1 we completed a \$100 million accelerated share repurchase and received 11.5 million shares at an average price of \$8.72 per share. Since November 2006, we have used \$205 million to repurchase 29 million shares retiring 16% of our shares outstanding in the process.

We ended the quarter at \$361 million in cash and equivalents including the impact of the \$100 million we used in the accelerated share repurchase. Consistent with our first quarter seasonal patterns, we had a net use of cash for operations of \$14.6 million.

We expect to be cash flow negative in Q1 and Q2 and cash flow positive in Q3 and Q4 and for the year as our maintenance renewal cycles occur January 1 and May 31. I would also like to comment on our deferred revenues.

Deferred license revenues increased 6% from Q4 to a balance of \$58 million at the end of August. As Harry discussed, a significant portion of the software contracts signed were recorded in deferred revenue.

As we've mentioned in the past, selling hosted solutions, subscription licenses, milestone based or fixed fee service agreements caused the revenue to be deferred. With more sales of gold and platinum total care solutions and strategic human capital management subscription, our deferral rate will continue to be high.

Milestone based services are reasonable terms for customers in certain situations and we also expect this trend to continue. Total deferred revenues were \$275 million, down from \$322 million (Sic-see press release) at the end of the fourth quarter. This is a normal occurrence in our first quarter as deferred maintenance revenues decline in Q1 and Q2 and then increases in Q3 and Q4 with the maintenance renewals cycle.

This concludes my remarks regarding Q1. With that, here's our guidance for Q2, our quarter ending November 30. We want to provide a guidance range that reflecting the uncertain state of the economy.

For Q2 of fiscal 2009, we anticipate that total revenues will be between \$205 million and \$215 million. Quarterly service revenues are again expected to contract on a year-over-year basis. We estimate GAAP EPS in the range of \$0.03 to \$0.06 per fully diluted share.

Non-GAAP EPS is expected to be in the range of \$0.07 to \$0.10 per share. Our estimate of Q2 non-GAAP EPS excludes \$8 million of pretax expenses related to the amortization of acquisition related intangibles, amortization of purchase maintenance contracts,

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and stock based compensation charges and purchase accounting adjustments for acquired deferred revenue balances at an estimated 35% tax rate.

The services revenues shortfall in Q1 and anticipated softness in the economy make the revenue shortfall difficult to recapture. We now believe that as we focus more on margin and as a result of the economy, services revenues will decline approximately 7 to 8% on a year-over-year basis for the full year and analyst models should be adjusted to reflect this.

In 90 days time, we'll give you an update on the second half of the fiscal year. With the uncertain economic environment, we cannot affirm our prior full-year guidance. Given the current macroeconomic environment and the possible impact of the credit markets on our customers' spending patterns over the remainder of the year, we're not in a position at this time to give a more specific full-year outlook. On our Q2 earnings call, we would expect to outline any actions that we've implemented or have determined might be appropriate in order to manage the business in a challenging economic environment.

In closing I'd just like to say that we are operating in a business environment that has certainly become more challenging over the last several weeks. But we'll deal with this challenge decisively.

Our businesses has been substantially transformed since the merger and this provides us a good platform to respond surgically and appropriately. We are an asset rich company in many respects.

We have industry-leading solutions, a strong and growing customer base, a healthy balance sheet and a dedicated and talented employee base. While it is likely that our short-term business plan has been impacted as have many other software companies, we're confident that we have the leverage and tools to manage the business through these challenging times.

To summarize, I would say the following. First, Q2 and full-year revenues are likely to be impacted given the economic environment. This is most notable in our services business as I have discussed.

Second, we remain committed to improving operating margin although this'll be more challenging given lower revenue growth. Third, we are examining all levers to implement plans in our second half of the year.

We've shown that we can transform our business in the face a challenging conditions and we will update our full-year guidance in our next conference call in January. With that I would like to turn the call back over to Harry for some closing comments.

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

Thanks Rob. So while economic issues appear to be spilling over into industries outside of the financial services area and may well impact customer decisions in the short-term, there is no fundamental or systemic change in customer demand for our software. Overall, growth expectations may need to be adjusted but we still have healthy opportunities in several key markets including health care, strategic human capital management and yes, even in manufacturing.

Today we have not hit the panic button. What we're doing is remaining focused on managing the business through this changing environment. That what we do as leaders and as managers. Successfully overcoming the challenges of integrating Lawson and Intentia's business has prepared as well for these types of challenges.

We have already proven how much we can transform a business, invest in growth and improve margin under challenging circumstances. What we have accomplished at Lawson in the last two years gives me great confidence that we can effectively work our way through the current economic challenges. And while we cannot give specific full-year guidance at this time, I can assure you that we are committed to deliver improved operating profitability this year even though the current economic uncertainty makes this more challenging.

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In closing, I want to reiterate that I remain very positive about our people, our solutions and our prospects for the future. Operator, that concludes our comments. Now we're ready to take some questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Mark Murphy, Piper Jaffray.

Mark Murphy - Piper Jaffray & Co. - Analyst

Harry, are customers pushing back on the rates for consulting or is this -- do you think that this is essentially a function of utilization rates?

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

No, it's a function of there's less short-term demand. I think people are simply at this point questioning some of the projects that they ordinarily would have perhaps more easily approved and are simply second guessing whether this is the appropriate time to approve the project or not. And I'm talking about services engagements here, not software license approvals.

Mark Murphy - Piper Jaffray & Co. - Analyst

When you reference the idea that the economy really didn't impact you through August but yet you believe that's changed in September what -- is that based upon kind of looking at your bookings result for September, kind of the linearity in September? Can you talk to that or is it just based upon extrapolating off of the stock market and the headlines out there?

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

It's based on reading the newspapers and watching the news and listening to all of the various commentaries about what is happening not just in America but now also in Europe and other parts of the world. I think in these times, probably most companies are having a meeting to determine what investments they should proceed with and what investments they should postpone. So we don't want to be caught by surprise with that. We want to make sure that we manage our business in accordance with the current trends.

Mark Murphy - Piper Jaffray & Co. - Analyst

So also if we put a lot of credence in that deterioration of the environment, it feels like you're heading into a year where license revenues should be down year-over-year. We have heard your comments on the likely trend on the services side of the business.

Can you help us with the sensitivity of maintenance growth to license growth? In other words, if your licenses are down say 10 or 20% this full year, how do you think the maintenance revenue line would perform?

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

First of all, we did not say that our license revenue are going to be down. In fact license revenue year-over-year will grow. I will give you the details about that at the end of our second quarter.

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Also, in the September month we actually didn't see any slowdown in September in terms of contracting. Don't forget as I mentioned in my comments, a number of deals that slipped out of Q1 were signed. In fact most of them were signed already early in September.

And so we expect the deal velocity and in fact have seen deal velocity in September happen pretty much as it has happened in other quarters. So we're reacting more to the news that we read in the newspapers and on television and what we hear commentators say rather than to what actually happened to us so far.

Mark Murphy - Piper Jaffray & Co. - Analyst

Maybe a final question for Rob. I'm interested to get your thoughts on ongoing share repurchases versus other potential uses of cash. I guess the stock has created a better opportunity. Since you did the accelerated share repurchase, are there any updated thoughts there?

Rob Schriesheim - Lawson Software, Inc. - EVP and CFO

You know we haven't had any updated short thoughts that we're prepared to share with the investor base. We have about \$139 million in our current authorization that is still outstanding and we have always been pretty consistent that we would evaluate the markets and conditions and make our judgments at that time.

Clearly in my view given the uncertainties of the economy, I think more cash is better, to be quite honest. We have got a very strong balance sheet and we will keep you apprised of what we do.

Operator

Peter Goldmacher, Cowen & Co.

Peter Goldmacher - Cowen and Company - Analyst

Harry, just following on something you mentioned to Mark, you said license revenues are going to grow which would be great. But you're down 17% year-to-date '01 you're going to be down about 20% in '02 according to guidance. So are you talking about license bookings are going to grow or license -- total license for the year as recognized on the income statement?

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

License revenue will grow and license bookings will grow. Don't forget, we have more than I think I said \$57 million in deferred license revenue on our balance sheet, Peter, a significant portion of which we expect to take into revenue this year.

Peter Goldmacher - Cowen and Company - Analyst

Right, okay well -- but if bookings that's your new license, if that's going to grow, that's I think what investors (multiple speakers)

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

Even with the slowdown, the way we see the market today, we expect both bookings to grow and license revenue to grow.

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Peter Goldmacher - Cowen and Company - Analyst

Okay, and on the services business, you guys have talked for a couple of quarters now about pushing more work out to partners sort of making your headaches their headaches as it turns out. So we would love if you could give a little more detail around that and then if you could talk about other potential opportunities to control costs beyond the offshoring, that would be great. Thank you.

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

Peter, we -- the reason we think we (inaudible) bigger (inaudible) ecosystem is not necessarily to do with headaches. We think that it creates a bigger pool of people upon which we can draw in times of high demand and also a pool of people that can offer services at a more competitive price. So it gives our customers some choices which we think will help accelerate services implementation.

So that's the primary reason we're going to a partner model and accelerating the partner model. Secondly, there are many levers we can pull in terms of the margin improvement. There are many -- there's training, there's education, there's tools, there's methodologies. We have actually packaged implementation approaches. QuickStep as an example is a great tool which delivers services, methodology and content.

All those areas have in fact -- where they have been successfully implemented, where a services organization has deployed everything we have asked them to deploy, have shown that we can get very high margins. I will give you an example.

For the last three quarters in the Americas region, our margins have been in excess of 20% every single quarter, even in Q1. So we just don't have a uniform deployment of all those tools and techniques around the world in all of our various services businesses. And that is really what we have to set our mind to.

And you may recall that we I think earlier this week announced the official appointment of Eric Verniaut as our new Executive Vice President of Services. He joins us in a month's time on the 3 of November and I'm looking forward to him joining us because I think he'll bring a lot of great experience to the table to help us achieve those goals.

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

One follow up to Peter's question. I do want to reiterate what I said in my comments is that I believe in the second quarter, this quarter that we're in, we will get reasonably close to 20% services margins on a worldwide basis. So it will be excluded from just the Americas, as an example. Next question please.

Operator

Steve Koenig, KeyBanc Capital Markets (Operator Instructions)

Steve Koenig - KeyBanc Capital Markets - Analyst

I guess if I have one question it's probably if you all go with -- if we achieve the license growth you're targeting and the license contract growth for the year, what should we expect for operating margins? Would we still expect to exit the year at 15% or would it be less than that or directionally up? If there's any help you could give us on that. And then just to confirm, are you still determining is there a material weakness yet in the Q, have you determined that yet?

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

I will take the first one, Steve. At this point as Rob said and I reiterated that I don't think we are in good position to give you full-year guidance. I can tell you that we have not given up on our objective of achieving 15% in specific quarters.

Whether we make that for the year, under these current economic conditions frankly that would be really challenging. I will tell you that. But I think what we can do is give you a much better perspective on this whole question of total revenue and total margin for the quarter -- for the year I should say, at the end of our second quarter. Maybe Rob, do want to take the question on material guidance?

Rob Schriesheim - Lawson Software, Inc. - EVP and CFO

Sure, so as far as whether or not we have a material weakness, the Company is evaluating its internal controls over financial reporting, in other words, our control environment. And we will make a final determination shortly and that would be disclosed in our 10-Q which we expect to file in the next two days.

Operator

(inaudible) [Wadell Reed].

Unidentified Participant

Harry, you used the phrase 'quality of pipeline' when referring to the pipeline and 'spotty' when referring to the services business. I'm wondering if you could sort of characterize those a little more concretely and sort of what didn't happen right in the quarter and what you guys are doing to rectify that?

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

Okay so by quality of pipeline I mean how well qualified it is. It's very easy to put names into a pipeline and then put a -- ascribe a dollar value to each opportunity in that pipeline. That's kind of a lazy man's way of doing it. It's not the appropriate way of doing it because you can lull yourself into thinking that your pipeline is good and if you use half pipeline conversion rates, high-level math, then you feel you've got an excellent chance.

In fact you may have more coverage than you normally need to deliver the quarterly results. And as we looked at some of the -- a number of the transactions in the pipeline, as we broke it down we found that they were not as well qualified or as late stage as they should have been and therefore I say the quality of the pipeline was not as high as it had been in previous quarters.

In terms of the spotty performance, I mean spotty in either business unit or geographic regions. Certain parts of Europe and Asia were weak in our first quarter. Some of it had to do with the fact that there were vacations. Some of it had to do with the fact that in some of those regions our headcount was actually significantly below budget.

In fact, in our services organization in Q1, we were about 80 heads below our budget. So you can't make that up overnight. When you don't have the people to bill the hours, the revenue isn't there. So that's what I mean by spotty performance.

Unidentified Participant

If I might follow up, did you have to go outside at all anyplace to utilize service hours?

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

We do and we always do. There is approximately -- I'm going to say something like 15% of our hours or our revenue every quarter is in fact subcontracted to third-party firms, our partners. In fact in some cases we have formal relationships with partners where we deliver to them on a regular basis a significant number of hours and work. That is very much part of our (inaudible) ecosystem model and that doesn't change, hasn't changed now for some time. We probably had this in place for two or three years now.

Unidentified Participant

I guess my question -- it wasn't a disproportionate share this quarter for any reason?

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

Actually I would tell you that that share was lower this quarter and last quarter than it has been in previous quarters. And that was a bit disappointing and we're scratching our heads trying to figure out why that is.

Operator

Richard Williams, Cross Research.

Richard Williams - Cross Research - Analyst

I wonder if you could give color on the manufacturing segments both US and Europe to help us understand if possible whether this is a market cap related or revenue size related issue or if there are verticals that are particularly effective, just any color you can help us with?

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

Sure, I would tell you that the answer is no. You may recall as well that Q4 and for much of last year, the M3 business which targets the manufacturing sector was exceptionally strong. We had a fantastic year and (inaudible) business pretty much around the world was in great shape.

It could be as I mentioned that in some respects we drained a little bit of the pipeline. I said that some quarters everything seems to go your way and some quarters it's a bit more challenging. Frankly Q4 deals that we have not forecast just started to pour in the last week and a half. We just simply could not shut the tap off almost. It was amazing.

That doesn't happen very often. But when it does obviously you have great support and it shows you are doing some things right. But when that does happen as well then it means that chances are you're not going to be off to a great start in the new quarter.

So I don't think you should read too much into this. I think that our M3 product is strong, it's getting stronger. We have great feedback from our customers, from industry analysts. I think that we will recover in the M3 area.

Richard Williams - Cross Research - Analyst

So this you don't think is a credit crisis related issue so much as (multiple speakers)

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

Not last year and not so far. Again, I do not have 20/20 vision into the future. And it is possible that other companies just like ourselves are looking at the future and saying we're not really sure what's going to happen and let's just be a little bit more cautious about how we spend money especially if those customers require debt financing to fund such transactions or such initiatives. Then I think it could well place those opportunities at risk.

Operator

David Bayer, Cantor Fitzgerald & Co.

David Bayer - Cantor Fitzgerald & Co. - Analyst

Actually the last question got to a lot of what I was going to ask about which is the M3 versus S3 bifurcation in demand. So I'll probably not ask that question given what just went on, unless you want to add some more color there.

But I do want to go back to that goal of the services margins getting up to 20% this quarter. That seems pretty aggressive in terms of moving people around. Maybe you could help us with a little bit more thoughts on how you could do that so quickly.

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

Okay, well actually in my -- if you look back over last year, it's really not that quickly because if you look at, Q2, Q3 both were north of 17%. Q4 was 18% and sure, Q1 was low. But Q1 is always going to be below because of the vacation period.

So I think you have to put Q1 aside as an exceptional time. If you think about where we were in Q4 18%, going from 18 to 20 is really not that big of a stretch. We've also been talking to you about many, many initiatives.

If you go back through our transcripts of earnings calls, all of last year we itemized about a half a dozen initiatives in which we were investing to help us achieve the plus 20% margins. And so I am not saying we're going to be necessarily plus 20% this quarter but I said we would be approaching 20%. So it's really not a giant step forward.

David Bayer - Cantor Fitzgerald & Co. - Analyst

Okay and the only other thing I would maybe ask about is the applications business for Oracle in particular (inaudible) company was not very robust in their most recent quarter also. And I'm just sort of wondering if you could give us some thoughts on maybe behavior in the marketplace. Is there more aggressive bidding between vendors or is that not really changed or is this -- sort of your thoughts on perhaps the overall competitive environment right now.

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

No, we see pretty much the same behavior. There are three or four competitors that we see around the world. We see Oracle, we see SAP, we see in certain markets Microsoft. You know, actually the nice thing about competing against those vendors on a regular basis is you get to over time understand them and learn their tactics and strategies. And so I haven't seen anything unique or different happen this quarter or the last quarter that we were in, Q1, or the quarter we're in right now. I think everybody is pretty much playing true to form.

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Operator

Greg Dunham, Deutsche Bank.

Greg Dunham - Deutsche Bank - Analyst

This quarter you had a lot of revenue that was deferred as you're contracting number was good. Now thinking back historically, that typically would happen with Intentia accounting rules or milestone agreements but you mentioned the increased I guess customer adoption of your hosting solutions. Is that a -- by product area that that's happening?

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

So here's how it -- no, it happens to both S3 and M3 by the way. It happens -- once you have bundled software with a hosting arrangement, it creates an accounting trigger, a (inaudible) trigger which causes the transaction to be deferred. And so the question is do you do the right thing for the customer or do you do right the right thing for P&L this quarter?

We're choosing to do the right thing for the customer. The revenue is not going anywhere and in many cases the customers are paying us the cash. It's unfortunate the rules are what they are but that's what they are.

So, we think that offering the customers a bundled solution is actually in our interests. It is the right thing to do. It makes the customers solutions richer. It allows us to focus on the things that we do well and it allows them to focus on things they do well. Unfortunately the rules don't allow us to recognize the revenue.

Greg Dunham - Deutsche Bank - Analyst

That makes sense. I guess then the follow would be what percentage of deals are done that way? And then a follow up to that is what do you see your CapEx requirements going forward because of it?

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

Historically very few because we've only relaunched this about a year and a half ago, the hosting option. But I would tell you that I'm very pleased about the success we have had and the success that -- and we launched it because frankly customers were asking for it. They were saying that if you don't offer it to us, we will go to somebody else.

Now here's the funny thing. If I were to sell you the software and then suggest you go somewhere else for the hosting, we would get 100% of the license revenue recognized today, the day we shipped it to you. But if you get the hosting for me, it gets deferred. How silly is that?

So that's one of the quirks of the rules. But I do believe that more customers over time will in fact opt for this because it's a good solution for them. Now your question about our CapEx requirements, we actually don't do the hosting ourselves. We subcontract the hosting out to one of two vendors, IBM being one of them. And so we're not in the business of building a bunker, an infrastructure bunker and so we manage that through a third party relationship.

Greg Dunham - Deutsche Bank - Analyst

That's helpful. Thank you.

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

And just a follow up in terms of CapEx, I just wanted you to understand that most cases those customers are actually paying us the license fee in advance. The only thing that's paid over time is the hosting fee and our expense is also variable over the life of that hosting arrangement. So that really doesn't have pressure on our CapEx or our cash in any way.

Operator

Brad [Sills], Barclays Capital.

Unidentified Participant

My question is really just on M3, some of the verticals in the US that you're selling M3 into in the US in particular. Were there some that you had more success in over the quarter or some that you are finding more difficulty in? And maybe just speak a little bit to what are some of the hurdles beyond the quality of the pipeline etc.

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

There are four primary verticals that we are selling. Those are fashion, food, wholesale distribution, and equipment service management. And then there are some other generic market segments as well. But those four are the ones that are our targets.

I would tell you that in Q1 we were universally weak, if I can tell you that. But that wasn't true in Q4. That wasn't true in Q3. It wasn't true in Q2. I don't suspect it will be true this quarter either. But it was true in Q1.

Unidentified Participant

And then just a follow-up question on the deferral -- the question on the higher deferral rate. Just curious, what's changed i.e. when you look at the year-over-year deferral rate increasing? Is it just more a higher attach rate of services into license deals or is it purely the hosting solution that is starting to kind of gain traction?

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

No; it's many, many different things. And as I said, it's very deal specific. So you could have a quarter where the nature of the deals has very little of the things that attract deferral and other quarters where the deal mix simply will attract a higher percentage. As I said, it's really unusual for us to have such a low deferral sort of conversion rate as we have had this quarter.

It was the lowest we have had in the last four, five years in fact. However to be prudent, we should manage our business and manage our expectation at a cautious rate. We do expect that customers will opt for hosting. We do expect that customers will ask for fixed-price agreements especially in these sort of economic times. We do expect that customers may ask for milestones to be achieved and all of those requirements and agreements would trigger a deferral.

By the way, this whole business of deferral, it seems to be -- everybody loves it. If you are a SASS company and yet if you're a company like us, for some reason people don't love it nearly as much which is kind of peculiar isn't it?

Unidentified Participant

Yes, a little catch-22 there. All right. Thanks guys.

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Operator

Mark Schappel, Benchmark.

Mark Schappel - The Benchmark Company - Analyst

Harry, on the last earnings call you stated that you'd like to see the sales headcount increased by about 15% year-over-year. And given the quarter's shortfall and the slowing economy here, did you plan to lower that sales headcount growth number this year or do you still plan to maintain that?

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

Well so I'll just remind you that in my comments I mentioned that [AE] headcount went from 198 people at the end of Q4 to 211 at the end of Q1. So we did in fact true to form as predicted, we did in fact hire some people.

Now to be honest right now we are evaluating how much -- how many more people we should hire. If we weren't as nervous about the economic conditions, frankly we would be hiring to that level you know starting tomorrow. I think what we're doing right now is reviewing those kind of investments to determine whether this is the right time or not.

Operator

There's no further questions at this time.

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

Operator and everyone, thank you for our call; appreciate the questions and we look forward to speaking with you at the end of our second quarter.

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