

palmOne, Inc. First Quarter, Fiscal 2005 Results Teleconference Remarks

Dave Vadasz, Sr. Director, Corporate Development and Investor Relations- palmOne, Inc.

Thank you, and good afternoon. I'd like to welcome securities analysts, stockholders and others listening today to palmOne's first quarter results conference call. On the call today are Todd Bradley - Chief Executive Officer, Philippe Morali – interim Chief Financial Officer, Ed Colligan – President and Ken Wirt – Senior Vice President, Marketing and Product Management. Today's call is being recorded and will be available for replay on palmOne's Investor Relations homepage at www.palmone.com. In addition to the press release, a copy of today's prepared comments and supplemental financial information will be available on the investor relations website.

I'd like to remind everyone that today's comments, including the question-and-answer session, will include forward-looking statements, including, but not limited to, a forecast of future revenue and earnings and other financial and business activities. These statements are subject to risks and uncertainties that may cause actual results and events to differ materially. These risks and uncertainties are detailed in palmOne's filings with the Securities and Exchange Commission, including its Form 10-K for the fiscal year ended May 28, 2004.

Also, please note that in addition to reporting financial results in accordance with Generally Accepted Accounting Principles or GAAP, palmOne routinely reports certain non-GAAP financial results. These non-GAAP measures, together with the corresponding GAAP numbers and a reconciliation to GAAP, are contained in our earnings press release and are posted on our website. We encourage listeners to review these items.

Finally, I would like to invite each of you to attend our 2004 Analyst Day being held on October 5 in New York. If you have not received a save-the-date email about the event, please email us at investor.relations@palmOne.com or call us at 408-503-7200 with an indication of your interest.

I'd now like to turn the call over to our CEO, Todd Bradley.

Todd Bradley, President and Chief Executive Officer- palmOne, Inc.

Thanks Dave, and good afternoon everyone.

I am pleased to report that palmOne entered FY '05 with strong revenue growth and profits. Our financial performance during the first quarter continues to validate our strategic direction. Here are some highlights from the quarter:

- We grew revenue 62 percent year-over-year, with Q1 being the fifth consecutive quarter of year-over-year revenue growth;
- We expanded gross margin to 33.3 percent, compared to 30.5 percent in the fourth quarter of fiscal 2004 and 28.1 percent in the year ago quarter;
- We expanded operating margin to 8.5 percent, and non-GAAP operating margin to 9.3 percent, compared to a negative 9.2 percent and a non-GAAP negative 7.5 percent in the year ago quarter;
- We generated \$19.6 million of net income and \$21.9 million of non-GAAP net income;
- We increased inventory turns to 44 compared with 21 in the year-ago period; and
- We increased cash and investments by \$37.9 million, including \$31.3 million from operations.

During today's call I will summarize our strategy and then spend a few minutes discussing the smartphone opportunity and outline some of the key actions we are taking to capitalize on this opportunity. I will then provide some thoughts on our priorities going forward. Philippe Morali, our interim CFO, will then give a detailed explanation of our Q1 financial results, and provide guidance for the coming quarter and updated guidance for our fiscal year 2005.

Our objective is to be the leader in the handheld computing and communications market. To achieve this goal, we are executing a four-pronged strategy.

- First: We are developing great products that deliver an outstanding user experience. Success in the handheld computing and communications market is determined by great products, and we are confident that no other handheld company offers a comparable user experience.
- Second: We are capitalizing on industry trends, such as the emerging ubiquity of high-speed wireless data networks which enable true "always on" connectivity. And the ever increasing variety of information and content – from business documents to photos and music – that is available in digital and therefore portable format. And, finally, the trend toward what we refer to as "platform phones", which enable sophisticated applications to run on mobile phones.
- Third: We are leveraging our leadership position in handheld computing. We are able to produce solid financial results from this product line, and it also contributes a brand, scale and a technology development platform that can be leveraged across our entire product portfolio. We believe this market can be reinvigorated and our leadership extended.
- Fourth: We are increasing smartphone adoption via a family of smartphones, delivering breakthrough applications, developing strategic carrier relationships and leveraging our loyal customer base.

We believe that, over time, a majority of all mobile phones sold will be smartphones. While it is difficult to predict timing – and, clearly, we are at the very early stages of market development – we continue to see signs that this vision is materializing. Carriers are increasing their commitment to this category and sell-through continues to accelerate. The catalysts for this growth started with the deployments of high-speed wireless data networks and advancements in underlying device technologies, each of which has played a role in enabling new applications. From there the market will continue to develop through broad based carrier distribution and promotion. Finally, as more and more users are exposed to the capabilities of smartphone solutions, we feel confident that the market will grow rapidly.

The smartphone space represents a high growth opportunity, and the Treo is a category-defining product. As the opportunity unfolds we expect other companies to follow our lead. It's important to note that more than one company will succeed, and we believe that palmOne is well positioned to be one of the leading players. We are confident in our ability to continuously add new functionality to our products, while masking the complexity by delivering a simpler user experience. With differentiated solutions in our portfolio, we will work to expand our carrier relationships and increase our total addressable market.

A cornerstone of our development approach is to leverage industry standard platforms and to deliver a "platform phone." This approach presents a number of substantial advantages. Our core premise is that players outside of palmOne can contribute greatly to the user experience. By leveraging industry platforms and making available our platform elements, we are able to harness the creativity of thousands of developers. We believe that a platform approach is the best way to meet customer needs over the long term. An example of how this benefits palmOne can be seen in the ways we have extended the underlying operating system and in the range of applications available on our platform phone.

- First, our own developers have added substantial value on top of the standard Palm OS release. The entire telephony architecture, five-way navigation, MMS and SMS capabilities, email application, and a plethora of other applications are all developments of palmOne. In fact, a majority of our engineers are focused on software development.

Beyond our internal developments, we benefit from third-party developers like:

- Good, Seven, Intellisync, Visto and Snapper offer email solutions covering each segment of the market – individuals, small and medium businesses, and enterprise customers;
- Sonic Mobility allows IT professionals to wirelessly manage their IT assets;
- Pocket Real Estate provides wireless access to Multiple Listing Service data;
- Sendia Wireless, iAnywhere and Extended Systems enable sales professionals to access their sales force automation data;
- Epocrates allows medical professionals to check drug interactions;
- Kodiak Networks enables Orange customers to add push-to-talk capabilities to their Treos; and
- Audible allows individuals to listen to the latest books, and public radio programs, newspapers and magazines.

As you can see, there is a rich and diverse set of applications available for our smartphone solutions, which benefit a full spectrum of customers.

Now, turning to our accomplishments in the first quarter of fiscal 2005:

- We successfully ramped production of Treo 600.
- We announced a relationship with Verizon – the largest carrier in North America. With the addition of Verizon, palmOne has now secured relationships with the five largest carriers in the United States. We are also happy to note that Verizon has already placed additional orders and is currently working to expand distribution beyond their business-to-business channel into their retail store locations.
- We announced a significant expansion of our relationship with T-Mobile. Previously, T-Mobile sold exclusively through their business-to-business channel and now sells across all major channels, including their direct and indirect retail channels and web store.
- At the beginning of this quarter we also announced a relationship with Bell Mobility – one of the top two Canadian carriers. Today, palmOne has 9 strategic carrier partners – and outstanding coverage of the North American market. In total, the Treo 600 is sold into 39 carrier channels worldwide.
- We continued to invest in our carrier-facing activities and have more than doubled our carrier sales team. In addition, we have aligned our business-to-business sales activities with those in place with our various carrier partners to streamline our go-to-market activities.
- Working with leading email providers, we have seen an acceleration of enterprise adoption of the Treo 600. For example, there are approximately 2400 corporations that have deployed GoodLink, from Good Technologies, running on the Treo 600. That's up 70% sequentially.
- We capitalized on Sony's reduced commitment to the U.S. handheld computing market and increased our share. According to the most recent monthly sell-through report from NPD, across US retail and commercial channels for the month of June, our market share was approximately 65%. That is up from the 60% share discussed in the previous quarter and approximately 40% in the same period last year.

Going forward we will continue to support our strategy with the following actions: Successfully execute our Fall product launch and continue to invest against the smartphone opportunity. This investment is aimed at building a family of smartphone solutions, enhancing our out-of-box email experience and expanding the depth and breadth of our carrier relationships.

To summarize, palmOne is well positioned to be a leading player in the rapidly expanding market for handheld computing and communications solutions. We have critical assets that we are leveraging to our advantage and we are executing a strategy that is tuned to market dynamics. We believe the result will be continued growth and profitability.

I'll now turn the call over to Philippe.

Philippe Morali, Interim Chief Financial Officer- palmOne, Inc.

Thank you, Todd. Good afternoon, everyone, and thank you for joining us today.

I am very pleased with our financial performance this quarter. We started fiscal year 2005 on a strong note as we achieved or exceeded our financial goals. The market is validating our vision and strategy, demand for our products is strong, and we are executing very well.

palmOne revenue for the first quarter of fiscal year 2005 was \$273.1m, up 62% compared to revenue of \$168.6m for the year ago quarter, which did not include any Smartphone revenue. This quarter's earnings per share of 38¢ compares very favorably to our per share loss from continuing operations of 57¢ for the same quarter of last year. Non-GAAP earnings per share, which excludes pre-tax charges of \$2.3m from the amortization of intangible assets and deferred stock-based compensation, were 43¢ this quarter. This also compares very favorably to last year's Q1 non-GAAP loss per share of 48¢.

Our revenue mix in the first quarter of fiscal 2005 was as follows:

1. Handheld related revenue was \$144.2m, a 14% decline from Q1 of fiscal 2004. Our handheld related revenue was comprised of shipments of 708 thousand units and \$14.9m of accessories and services. Unit shipments grew 10% year-over-year, while blended ASP of \$183 was down 21% year-over-year because of continued strong user demand for the Zire 31 and the Tungsten E, featured at the low end of our pricing range.

Handheld units sell-through was up 2% on a year-over-year basis, reversing the year-over-year declines we experienced in Q3 and Q4 of fiscal 2004, of 8% and 7% respectively.

At the end of Q1, our handheld channel inventory was at approximately 8 weeks, within our desired range of 6 to 8 weeks.

2. Smartphone related revenue was \$128.9m, comprised of 273 thousand Treo 600s and related accessories. We executed well on our plan to increase smartphone shipments. Smartphone shipments grew 81% sequentially, and ASPs remained stable compared to the last two quarters. Including 48 thousand shipped by Handspring pre-acquisition, we have now shipped 661 thousand Treo 600s since its market introduction last fall.

Smartphone sell-through grew 42% sequentially during Q1, versus 13% during Q4 of fiscal 2004, representing continued strong user demand, step function increases in our addressable market as a result of new carrier adoptions, and improved component supply enabling the carriers to increase market development efforts.

At the end of Q1, our smartphone channel inventory level was at approximately 10 weeks. We are comfortable with this level because shipments were skewed towards the third month of the quarter, and because we are seeing increasing sell-through and marketing initiatives from carriers.

Our revenue mix this quarter was 53% handhelds and 47% smartphones, consistent with a seasonally low handhelds quarter, and with the strong supply performance we delivered on smartphones.

U.S. revenue, at \$191.8m, grew 86% over our FY'04 comparable quarter and comprised 70% of total revenue. International revenue grew 24% year-over-year, to \$81.3m. This is consistent with the relatively slow summer months in Europe and the addition of Verizon this quarter, the largest U.S. carrier.

Impact from currency fluctuations was not significant this quarter.

With regard to the key components of our business model during Q1 of fiscal 2005:

Gross margin, which includes a portion of the amortization of intangible assets and deferred stock compensation, was 33.3%. This is significantly above the 28.1% reported in Q1 of FY'04. Our handheld product line contributed about one third to the gross margin increase. This quarter, we experienced a more favorable competitive environment than we did a year ago, reduced inventory related charges as a result of lower inventory levels, and lower technical support costs due to lower call volume and lower cost of delivering services. The remaining two thirds, or so, of the gross margin increase resulted from the addition of smartphones in this quarter's revenue mix relative to that of a year ago. Our smartphones carry higher gross margins relative to handhelds.

Operating expenses were \$68.3m or 25.0% of revenue, versus \$62.9m or 37.3% of revenue in the comparable year-ago quarter. Non-GAAP operating expenses, which exclude the amortization of intangible assets and deferred stock-based compensation, were \$65.9m for the first quarter of fiscal 2005. As a percent of revenue this quarter's non-GAAP operating expenses were 24.1%, comparing very favorably to the 35.6% in the first quarter of fiscal 2004, as we have grown revenue much faster than we have grown operating expenses over the past year.

Our operating expense spend was lower than we expected this quarter, largely due to delays in hiring and project related spending which contributed to lower than expected R&D expenses, and delayed trial proceedings, which contributed to lower than expected G&A expenses.

As a result of our strong gross margin performance and operating expense under-spend, our profitability this quarter was better than we had forecasted.

Operating income stood at \$23.1m or 8.5% of revenue. Non-GAAP operating income, which excludes the amortization of intangible assets and deferred stock-based compensation, stood at \$25.4m, or 9.3% of revenue.

Net income was \$19.6m or 7.2% of revenue. Non-GAAP net income, which excludes the amortization of intangible assets and deferred stock-based compensation, was \$21.9m, or 8.0% of revenue. This compares very favorably to our Q1 FY'04 net loss from continuing operations of \$16.9m and non-GAAP net loss of \$14.1m.

Our working capital management performance was strong this quarter and helped further strengthen our balance sheet. Cash and short-term investments totaled \$290.3m at the end of Q1 of FY'05, \$37.9m higher than last quarter. We generated \$31.3m of cash flow from operations during the quarter.

The company's net accounts receivable Days Sales Outstanding was 44 days for Q1 of FY'05. This is 4 days higher than the same period last year, driven mainly by heavier shipments in the third month of the quarter, offset somewhat by strong collection performance.

Our inventory balance decreased by \$4.8m from a year ago to \$19.2m, reflecting exceptional inventory turns of 44. This is the result of very effective inventory management.

The resulting cash conversion cycle (receivable days + inventory days – payable days) was negative ten days for Q1, which means that we generated cash from working capital during the quarter.

Now, I'd like to spend a moment discussing our expectations for the upcoming second quarter of fiscal 2005, and update our guidance for our full fiscal year 2005. It should be noted that we do not intend to update these comments or forecasts prior to our next quarterly conference call.

For our second quarter of FY'05:

1. We are estimating revenue of \$370m, which represents 36% growth over the second quarter of last year. We expect high single-digit year-over-year decline in handheld revenue, and continued sequential growth in smartphone revenue, albeit at a lower rate than that we experienced in Q1 of fiscal year 2005, which was favorably impacted by prior quarters' supply constraints.

In that Q2 is typically a strong seasonal handheld quarter, we expect our revenue mix to shift some towards handhelds relative to the Q1 mix.

2. We are also estimating earnings per share, for Q2 of fiscal 2005, at 46¢.
3. Non-GAAP earnings per share for Q2 are forecasted at 50¢, which excludes pre-tax charges from the amortization of intangible assets and deferred stock-based compensation of approximately \$2.2m.

We expect gross margins to be lower in Q2 of fiscal 2005 than the fiscal year average, because of holiday promotions and pricing actions related to fall product introductions and transitions. Operating expenses in Q2 of fiscal 2005 will increase sequentially both because of investments in engineering and sales and marketing, as well as because of holiday sales and marketing expenses.

We see an opportunity to increase our sell-through of handhelds as our market position has improved and our product lines favors the holiday buying trends. We also have increasing smartphone sell-through momentum, and we want to push the awareness of our solutions both with our own promotional efforts and in conjunction with carriers who are planning to increase their marketing spend related to our products.

For our fiscal year 2005, ending on June 3rd, 2005, we are revising our guidance upwards, to reflect the strength we have experienced in Q1 and our outlook for the year. Our guidance for fiscal 2005 is now as follows:

1. Revenue in the range of \$1.27-1.31 billion, which at the mid-point of \$1.29 billion represents an increase of 36% over FY'04. This is about \$40m higher than our previous FY'05 revenue guidance.

Consistent with handhelds seasonality and with our expected pattern of smartphones growth during the fiscal year, we expect our Q2 and Q4 quarters to be higher than Q1 and Q3. And we continue to expect the revenue mix between handhelds and smartphones to be approximately 50%-50% in Q4 of FY'05.

2. At the mid-point of the revenue guidance, we forecast gross margin between 29.5 and 30.5%, versus 28.7% for fiscal year 2004. This is about 1 percentage point higher than our previous gross margin guidance. As we exit Q1, the pricing environment for components appears more favorable than we expected entering the fiscal year.
3. At the mid-point of the revenue guidance, we forecast operating margin of 6.5 to 7.5% and non-GAAP operating margin of 7.5 to 8.5%, one percentage point above our previous operating margin guidance for FY'05.
4. Last quarter, we had estimated about \$15m of taxes for fiscal year 2005, primarily foreign. Because of the now projected greater profitability, we expect to have to provide non-cash taxes for the usage of Handspring net operating losses and other deferred tax assets that are required under acquisition accounting rules. This quarter, the impact of these accounting rules was offset by the favorable conclusion to a tax audit. We now expect \$20m in taxes for the year, which primarily consists of foreign taxes and acquisition accounting adjustments.
5. At the mid-point of the fiscal year 2005 revenue guidance, earnings per share are estimated at \$1.45 to \$1.60. Non-GAAP earnings per share for FY'05, excluding pre-tax charges of \$9m from the amortization of intangible assets and deferred stock-based compensation are forecasted at \$1.65 to \$1.80 per share. This is about 35 cents higher than our previous FY'05 guidance.
6. We expect to manage our cash conversion cycle between +1 and -3 days, driven primarily by projected sustainable inventory turns of 30, an increase from our previously guided level of 25.
7. Finally, our guidance for fiscal 2005 on diluted share growth remains unchanged from last quarter.

In conclusion, we continue to execute well and we achieved or exceeded our financial goals. Most importantly, we reached new levels of growth and profitability. Our business is strong and well positioned for the long term.

I hope to see you all at our upcoming Analyst Day, in New York City, on October 5th. We will share with you our thinking about innovation, and how deeply it runs within the Company. We also will share our views of the large market opportunity we are faced with, and how palmOne plans to capture a significant share of it.

I'll now turn the call over to the operator for your questions.

Todd Bradley's Closing Remarks:

Thanks everyone for joining us for today's call. I would also like to of course thank and recognize all of the employees of palmOne who have done such a great job of executing this quarter. In wrapping up, I'd like to invite all of you to join us on October 5th when we have our annual conference in New York. We look forward to seeing all of you there. Thanks and have a great day.

Cautionary Note Regarding Forward-Looking Statements

This transcript contains forward-looking statements within the meaning of the federal securities laws, including, without limitation, statements regarding our expected second quarter of fiscal year 2005 revenue, gross margins and earnings per share, our fiscal year 2005 revenue, gross margin, operating margin, taxes, earnings per share, diluted shares and cash conversion cycle and our ability to grow our business, revenues and profits, to execute our Fall product launch, to remain competitive and to extend our leadership position in our industry, our strategy, the growth potential for our market, demand for and acceptance of our products, including carrier relationships, carrier promotion of smartphones, supply of our products, revenue mix, seasonality, pricing, component cost, ability to use our net operating losses and our investments in engineering and sales and marketing. These statements are subject to risks and uncertainties that could cause actual results and events to differ materially, including, without limitation, the following: fluctuations in the demand for palmOne's existing and future products and services and growth in palmOne's industries and markets; possible defects in products and technologies developed; palmOne's ability to timely and cost-effectively obtain components and elements of our technology from suppliers; palmOne's ability to compete with existing and new competitors; palmOne's dependence on wireless carriers; palmOne's ability to utilize its net operating losses. A detailed discussion of these and other risks and uncertainties that could cause actual results and events to differ materially from such forward-looking statements is included in palmOne's recent filings with the Securities and Exchange Commission, including its Annual Report on Form 10-K for the fiscal year ended May 28, 2004. palmOne undertakes no obligation to update forward-looking statements to reflect events or circumstances occurring after the date on which this transcript was first recorded.

Non-GAAP Financial Measures

To supplement the company's consolidated financial statements presented in accordance with GAAP, palmOne uses non-GAAP measures of certain components of financial performance, including operating income (loss), net income (loss) and per share data, which are adjusted from results based on GAAP to exclude certain expenses, gains and losses. These non-GAAP measures are provided to enhance investors' overall understanding of the company's current financial performance and the company's prospects for the future. Specifically, the company believes the non-GAAP results provide useful information to both management and investors by excluding certain expenses, gains and losses that may not be indicative of its core operating results. These non-GAAP results are among the primary indicators management uses as a basis for planning and forecasting of future periods and facilitating management's internal comparisons to the company's historical operating results and comparisons to competitors' operating results. In addition, because palmOne has historically reported certain non-GAAP results to investors, the company believes the inclusion of non-GAAP measures provides consistency in the company's financial reporting. These measures should be considered in addition to results prepared in accordance with generally accepted accounting principles, but should not be considered a substitute for, or superior to, GAAP results. These non-GAAP financial measures may also be different from non-GAAP financial measures used by other companies. Consistent with the company's practice, you can find the reconciliation of the non-GAAP measures reconciled to the nearest GAAP measure included in this transcript posted to our Investor Relations website.