palmOne, Inc. Fourth Quarter, Fiscal 2004 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 fourth 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 Marketing. 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-Q for the fiscal quarter ended February 27, 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.

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 hello everyone.

I am pleased to report that palmOne concluded FY '04 solidly profitable, marking the achievement of a key objective for the company. Strong performance during the fourth quarter, along with an outlook of accelerating growth and consistent profitability, continue to support our belief that our strategy is working. A few highlights from the quarter include:

- We grew our revenue 23% on a year-over-year basis, with Q4 being the fourth consecutive quarter of year-over-year revenue growth;
- We expanded gross margin to 30.5%, compared to 26.5% in the year ago quarter;
- We expanded operating margin to 6.0%, compared to a 3.0% loss last quarter and a 4.6% loss in the year ago quarter;
- We reported $13.3 million of net income and $15.9 million of non-GAAP net income;
- We reduced inventory by $8.7 million from the same period last year, with inventory turns increasing to 36;
- And we generated positive cash flow from operations of $6.4 million.

My focus today will be to review our strategy and describe our competitive advantages. I will also outline some of the key actions we are taking to execute our plan. Finally, I will conclude with some thoughts on our priorities for the coming quarter and fiscal year. Philippe Morali, our interim CFO, will then provide a detailed explanation of our financial results for the quarter and provide guidance for the coming quarter and fiscal year.

Our objective is to be the leader in the handheld computing and communications market. To achieve this we have developed a four-point strategy: develop great products, capitalize on industry trends, maintain strategic contribution from handheld computing, and increase smartphone adoption. I'll now go through each one of these:

- First: Develop great products that deliver a great user experience.

  Success in the handheld computing and communications market is determined by great products. We continuously add new functionality to our products, while masking the complexity to deliver a simple user experience. We are confident that no other handheld computing company offers a comparable user experience and that our strengths in this area will continue to serve us well as we develop these products.

- Second: Capitalize on industry trends.

  Today we are focused on leveraging two key trends – first is the emerging ubiquity of high-speed wireless data networks which enable true "always on" connectivity, and second, the ever increasing variety of information and content – from office documents to photos and music – that is available in digital and therefore portable form. Both of these trends require, and reward, great handheld devices, which creates an opportunity for palmOne.

- Third: Maintain strategic contribution from handheld computing.

  As the leader in handheld computing, we believe that the market dynamics are favorable to palmOne. While the market for handheld computers – or connected organizers – is maturing, our leadership position and our ability to develop great products enable us to produce solid financial results from this business. This market also provides a brand, scale and a technology development platform that can be leveraged across our entire product portfolio.

- Fourth: Increase smartphone adoption.

  To achieve this we will focus on creating a family of smartphones, developing carrier partnerships and leveraging our loyal customer base. Our design approach to Treo 600, which provides equal emphasis to voice and data capability, allows us to appeal to the largest set of potential customers in the smartphone space. Also, with our computing heritage, we are able to work closely with carriers to deliver applications that make the advantages of high-speed wireless data networks available to customers. Finally, palmOne is the only player in the smartphone space that is able to capitalize on a large, and growing, installed base of PDA users to bring new users into the smartphone space.

In the fourth quarter we took several steps to execute this strategy.

- We launched two outstanding handheld computing products – the Zire 31 and Zire 72. The Zire 31 is the lowest priced color handheld computer on the market and is aimed at attracting the first-time buyer. Zire continues to grow the category, with more than 50% of buyers having never previously owned a handheld computer. The Zire 72 is the most media-capable handheld computer we've ever delivered and is an important step toward what we see as a shifting usage pattern from connected organizers to handheld computers that offer a rich multi-media experience. As planned, palmOne has continued to attract first-time buyers, traditional mobile professionals and digital media enthusiasts with our Zire and Tungsten handheld product lines.

- We announced two bundles to bring satellite vehicle navigation to our Zire and Tungsten lines of handheld computers – enabling voice-guided turn-by-turn driving directions. Satellite navigation is extremely popular in Europe and is poised for growth in the U.S. We estimate that approximately 450,000[1] navigation-enabled handheld computers were sold in Europe last year, and we expect that number to more than double in the coming year. Satellite navigation represents another example of how we are evolving handheld computing beyond core organizer functionality.

- Despite tough competition, we maintained industry-leading market share in the handheld computing space. According to the most recent sell-through report from NPD, across US retail and commercial channels for the month of April, our market share was approximately 60%. Also, according to the most recent sell-through report from GfK, covering the 8 largest European markets for February and March, our market share was approximately 41%.

- We increased Treo 600 shipments and saw a corresponding increase in sell-through.

- We announced two new carrier relationships for the Treo 600 smartphone – KPN in Belgium and Holland and Rogers Wireless in Canada.

- We worked with leading email providers to bring best-in-class email solutions to the Treo 600 user. Today there are strong offerings available with the Treo 600 for each segment of the email space – a POP3 client for the individual user; Seven and Visto targeting small and medium business users, and Extended Systems and Good targeting the enterprise user. Email is one of the key applications driving growth in the smartphone space, with over 75% of Treo buyers saying that email was a key factor in their purchase decision. In addition, we see continued strong enterprise adoption. For example, there are approximately 1400 corporations that have deployed GoodLink, from Good Technologies, running on Treo 600. That's up 40% from last quarter.

- We continued strong operational execution. This included transitioning to a new U.S. distribution partner and bringing greater efficiency to our call center operations. These changes impacted the income statement with improved gross margin and the balance sheet with increased inventory turns. Finally, we expanded our supply base for Treo 600 displays, which will enable us to capture additional revenue in the fiscal first quarter.

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[1] 45,000 was the number mistakenly reported on the call. The correct number is 450,000.

- Finally, last week we announced another step in the evolution of palmOne with the consolidation of the handheld and wireless business units under Ed Colligan as President of palmOne. In this capacity Ed will drive sales, marketing and engineering. I am confident that Ed will do a great job working with me to build on our momentum.

Looking forward, we will continue to support our strategy with the following actions:

- Continue to ramp production of Treo 600 smartphones. We expect to make significant progress against filling the current backlog, yet indications are that continuing strong demand could out pace supply in the coming quarter.

- Increase overall engineering investment and continue to shift emphasis toward smartphone solutions to build a family of smartphones. We will also continue to invest to enhance the breadth of advanced applications available for the Treo 600.

- Continue to create new and develop existing strategic carrier relationships.

- Further strengthen our leadership position in the handheld computing market. We are committed to bringing new users into the marketplace and continuing to earn the repeat business of existing customers. We believe our roadmap is strong and we will work to exploit the opportunity created by Sony's reduced commitment to the space.

We are very excited about the opportunity ahead for palmOne. We continue to focus on our long-term mission to put the power of computing in everyone's hands. 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 accelerating growth and increasing 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 pleased with our overall performance this quarter. Our products are being well received, we continued to increase smartphone supply, and we achieved or exceeded our key financial expectations. And our outlook for FY'05 is exciting.

palmOne revenue for the fourth quarter of fiscal 2004 was $267.3m, up 23% compared to revenue of $217.1m for the fourth quarter of FY'03. This quarter's earnings per share of 27¢ compares very favorably to our per share loss from continuing operations of 35¢ for the same quarter of last year. Non-GAAP earnings per share, which excludes pre-tax charges of $2.6m from the amortization of intangible assets and deferred stock-based compensation and restructuring costs, was 32¢ this quarter. This compares very favorably to last year's Q4 non-GAAP loss per share of 28¢.

Our revenue mix in the fourth quarter was as follows:

1. Handheld related revenue was $192m, a 12% decline from Q4 of fiscal 2003. Our handheld related revenue was comprised of shipments of 956 thousand units and $16.3m of accessories and services. Unit shipments grew 3% year-over-year, while ASP's declined 11% year-over-year because of strong demand for Tungsten E and the introduction of the Zire 31 at entry-level price points.
   Handheld unit sell-through was down 7% on a year-over-year basis, less then the 8% year-over-year decline we experienced in Q3 and the 11% year-over-year decline we experienced in Q2. Our focus on market expansion and our strong competitive position are positively impacting the unit sell-though rate.

2. Smartphone related revenue was $75.4m, which is at the high-end of our guidance, and was comprised of 151 thousand Treo 600s, related accessories and legacy products. Smartphone ASP's were higher than forecasted primarily due to GSM/CDMA mix.

   While we continued to increase the supply of Treo 600s in Q4, demand continued to outpace supply throughout the quarter. We benefited from increased supply from new component vendors toward the end of Q4, and we expect increasing benefits during Q1.

Smartphone sell-in and sell-through increased at comparable rates sequentially, representing continued end-customer demand.

U.S. revenues, at $165.6m, grew 43% over our FY'03 comparable quarter and comprised 62% of total revenue. We experienced faster growth domestically as the U.S. currently accounts for more than 60% of our Treo sales, consistent with our initial focus on U.S. carriers. We feel we have a strong growth opportunity as we further develop and expand carrier relationships internationally.

We achieved our Q4 revenue performance while managing channel inventory within our desired range.

With regards to the key components of our business model during Q4 of FY'04:

Gross margin, which includes a portion of the amortization of intangible assets and deferred stock compensation, was 30.5%. This was well above the 26.5% reported in Q4 of FY'03. Both handhelds and smartphones contributed to this improved gross margin performance. We have continued to improve the gross margins of our handheld computing products through disciplined cost and product-life cycle management, improved supply/demand management and reduction in our technical support costs. And this quarter also includes gross margin from smartphone products relative to the same year-ago quarter.

Operating expenses were $65.7m or 24.6% of revenue versus $67.4m or 31% of revenue in the comparable year-ago quarter. Non-GAAP operating expenses, which exclude the amortization of intangible assets and deferred stock-based compensation, and restructuring charges, were $63.1m for the fourth quarter. As a percent of revenue this quarter's non-GAAP operating expenses were 23.6%, comparing very favorably to the 30% recorded in the fourth quarter of FY'03, as we have grown revenue while reducing expenses over the past year.

As a result, operating income stood at $16m or 6% of revenue. Non-GAAP operating income, which excludes the amortization of intangible assets and deferred stock-based compensation and restructuring costs, stood at $18.6m, or 7% of revenue.
As these results demonstrate, we have significantly improved the profitability of our business through revenue growth, gross margin expansion and disciplined management of operating expenses. And we are committed to do more of this as we enter FY'05.

Net income was $13.3m or 5% of revenue. Non-GAAP net income, which excludes the amortization of intangible assets and deferred stock-based compensation and restructuring charges, was $15.9m, or 6% of revenue. This compares very favorably to our FY'03 fourth quarter's loss from continuing operations of $10.4m and non-GAAP loss from continuing operations of $8.2m.

We continue to improve our balance sheet and to effectively manage the conversion of net income into cash. Cash and short-term investments totaled $252.5m, $12.6m higher than last quarter. In total, cash flow from operations was $6.4m.

The company's net accounts receivable Days Sales Outstanding was 41 days as we exit the fourth quarter, 1 day higher than the same period last year.

Our inventory balance decreased by $8.7m from a year ago to $14m, reflecting exceptional inventory turns of 36. This is the result of very strong inventory management as well as constrained supply chain for smartphones.

The resulting cash conversion cycle (receivable days + inventory days – payable days) was negative seven days for Q4, which means that we generated cash from working capital during the quarter.

Now, I'd like to spend a moment discussing our expectations for our upcoming first 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 first quarter of FY'05, we are estimating:

1. Revenues in the range of $250 to $260 million, which at the midpoint of $255m, represents 51% growth from the first quarter of last year. We expect continued sequential growth in smartphone revenue, partially offset by a modest year-over-year decline in our handheld revenue. This revenue expectation includes shipments of about 240-260 thousand smartphones.

2. At the mid-point of the revenue guidance, earnings per share are forecasted at 12¢ for Q1 of fiscal 2005.

3. Non-GAAP earnings per share for Q1, at the mid-point of the revenue guidance, excluding pre-tax charges from the amortization of intangible assets and deferred stock-based compensation of approximately $2.2m, is forecasted at 17¢.

For our fiscal year 2005, ending on June 3rd, 2005, we are revising our guidance to reflect our expectation of continued strength in our business. As such, our guidance is as follows:

1. Revenues in the range of $1.21-1.29 billion, which at the mid-point of $1.25 billion represents an increase of 32% over FY'04. This is $158m higher than that resulting from our previous FY'05 revenue growth guidance of 15%. This increase is being driven by our expectations for lower declines in handhelds and strong growth in smartphones.

   We expect the quarterly seasonality of revenues during FY'05 to be consistent with that of FY'04. We also expect the revenue mix between handhelds and smartphones to shift from 72% handheld-28% smartphone in Q4 FY'04 to approximately 50%-50% by Q4 of FY'05.

2. At the mid-point of the revenue guidance, we forecast gross margin between 28.5 and 29.5%, consistent with our FY'04 level. This is in line with our expectation of a relatively tight supply environment, which could reduce the life-cycle cost-improvements that we have historically experienced. On the pricing side, we have assumed modest declines based on our current assessment of the competitive landscape.

3. At the mid-point of the revenue guidance, we forecast operating margin of 5 to 6% and non-GAAP operating margin of 6.5 to 7.5%, above our previous 2 to 5% non-GAAP operating margin guidance.

   It should be noted that operating margins tend to scale with revenue. As such we expect lower operating margins in Q1 and Q3 and slightly higher operating margins in Q2 and Q4 of FY'05.

   This improved operating performance also includes increased investments in engineering and sales and marketing relative to FY'04. We compete by creating innovative products with delightful user experience. And we differentiate further through deep strategic relationships with carriers. We believe now is the time to increase our investments in these areas to capture a greater share of the rapidly growing smartphone market.

4. For provision for taxes, you should assume $15M of foreign taxes for FY'05. We have a large NOL carry forward, which we expect to use to offset domestic tax liabilities.

5. At the mid-point of the revenue guidance, earnings per share are estimated at $1.15 to $1.25. This compares favorably to our FY'04 per share loss from continuing operations of $0.26. 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 is forecasted at $1.30 to $1.45 per share, compared with FY'04's non-GAAP earnings per share of $0.19.

6. Diluted shares are expected to grow by approximately 9% over the next year, or about 2.2% per quarter. This projected growth in our diluted shares is being driven by our normal stock option programs and assumed growth in our share price.

7. Finally, we expect to manage our cash conversion cycle between +2 and -2 days, driven primarily by projected sustainable inventory turns of 25, an increase from our previously targeted level of 20.

In conclusion, we intend to assert our leadership in the handheld and communications space; and as Todd mentioned, "we enter FY'05 with an optimistic outlook for accelerating growth and increasing profitability."

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

Todd Bradley's Closing Remarks:

Fiscal 2004 was a pivotal year for palmOne. We transformed the company through the spin-off of PalmSource and the acquisition of Handspring. Our strategy is working and we are excited about our future prospects.

Thanks, again, for attending and we'll speak to all of you soon.

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 first quarter of fiscal year 2005 revenue, unit shipments, and earnings per share, our fiscal year 2005 revenue, gross margin, operating margin, taxes, earnings per share, diluted shares, cash conversion cycle and inventory turns and our ability to grow our business, to be profitable, 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, supply of our products, revenue mix, seasonality, pricing, 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 Quarterly Report on Form 10-Q for the fiscal quarter ended February 27, 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.

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.