MKS INCORPORATED

Moderator: Philip Deck
November 27, 2007
4:00 pm CT

Operator: Ladies and gentlemen, thank you for standing by. Welcome to the MKS Second Quarter Fiscal 2008 Financial Results conference call.

During the presentation, all participants will be in a listen-only mode. Afterwards, we will conduct the question and answer session. At that time if you have a question, please press the 1 followed by the 4 on your telephone.

If at any time during the conference, you need to reach an operator, please press star-0.

As a reminder, this conference is being recorded Tuesday, November 27, 2007.

I would now like to turn the conference over to Philip Deck, Chairman and Chief Executive Officer.

Please go ahead, sir.

Philip Deck: Good afternoon and welcome to the MKS Second Quarter conference call. I'm here with Michael Harris, the President and Chief Operating Officer and Doug Sawatzky, our Chief Financial Officer in Waterloo.

But I'll first turn to Larry Wasylishyn, our legal counsel for the legal disclaimer.

Larry Wasylishyn: Thanks, Phil. Good afternoon.

Some of the statements made on this call including those relating to our strategies and other statements that are predictive in nature that depends upon or referred in future events or conditions or that include words such as "expects", "anticipates", "intends", "plans", "believes", "estimates" or similar expressions are forward-looking statements within the meaning of Securities' laws.

Forward-looking statements include information concerning possible or assumed future results of operations of MKS and its subsidiaries are not guarantees of future performance and involve certain risks and uncertainties that are difficult to predict. These statements are not historical facts, but instead represent only our current expectations, estimates and projections regarding future events.

The future results and shareholder value of MKS may differ materially from those expressed in these forward-looking statements due to among others those factors set out in MKS's filing of Canadian Securities regulators.

MKS does not undertake any obligation to update or release any revisions to these forward-looking statements to reflect events and circumstances after this call or reflect the occurrence of unanticipated events except as required by law.

I'll turn the call back to Phil.

Philip Deck: Thanks, Larry.

Today, MKS reported record quarterly revenues of $13.6 million, up 18% from the results in the comparable period in the previous year and up slightly from last quarter led by record ALM revenues of $11.9 million, up 23% from the same period last year and 1% above the first quarter of this year.

We achieved our results with record maintenance and services revenues results combined with licensing significantly better than the year-ago period, although slightly below last quarter.

Our interoperability business showed declines consistent with expectations, where we continue to manage cost well to achieve normal profit contributions.

We returned to overall profitability this quarter with almost $600,000 in pretax profits. Our net income was approximately $200,000 after utilization of over $500,000 of our deferred tax asset.

The extremely high nominal tax rate on pretax revenues due to the complexities of deferred tax accounting and has no impact on cash and nothing to do with our future ongoing tax rates.

We did record a tax credit of $150,000 based on cash (ITC).

In our ALM business, we did a record number of transactions over 100,000 per order, but no particularly large ones with the largest license transaction being less than $250,000.

More than usual, where initial orders for larger rollouts in the next few quarters, we saw particularly - particular strengths in the mid-size engineering firms based on our ability to unify their development efforts.

And as we continue to devote significant field resources to a number of longer and larger sales initiatives, which did not contribute to current results but are maturing steadily.

Our maintenance revenue set another all-time record at $6.4 million and an ALM maintenance record of $5.6 million. Maintenance revenue continued to show the effects of very high renewal rates of 90% overall with the top half of our maintenance revenue base renewing at 97%.

Services revenue of 2.1 million was also at a record level with 31% growth over both the year-ago results and last quarter and excellent utilization in margins.

Our services business continues to grow in absolute terms and relative to our license levels consistent with our strategy to ensure that customers are driving as much value as they can from our products.

Our customers continue to utilize our expertise in increasing amounts to plan and implement more complex and comprehensive ALM implementation. And like in the last three quarters, we booked many more services and we delivered further increasing our backlog.

Closing cash balance at July 31, 2007, was 9.9 million down from 11.9 million at August 31, 2007. Our cash has been affected by normal maintenance renewal seasonality and a significantly increased investment in receivables resulting from increasing sales activities in general and the delayed average close date of transactions in the quarter.

MKS is substantially impacted by changes in exchange rates between the US dollar, our reporting currency, and our other primary operating currencies, the Canadian dollar, the euro and the pound. The chief impact of currency changes this year has been to significantly increase the expenses we pay in Canadian dollars and modestly increase the net margins we earned in euros and pounds.

The average cost of Canadian dollars expense in the quarter was 98 cents US. While we don't explicitly hedge for currency changes, we did maintain higher than usual balances of Canadian dollars this quarter during the sharp run-up in value resulting in a one-time gain of approximately 300,000. The impacts of the high Canadian dollar in particular are challenging, but far from unmanageable.

MKS has already overcome more than 10 million in annualized currency related cost over the past four years through improved margins, improvements in administrative efficiency and a higher proportion (unintelligible) maintenance in our revenue stream.

We believe that we'll be able to adapt to any conceivable further changes over time. The recent rapid changes particularly in the Canadian dollar over the last six months had somewhat delayed the pace of our return to higher profitability levels, but we continue to make changes through our operating plans to adopt that prevailing currency environment.

I will now turn to Michael Harris for a review of Q4 operations.

Michael Harris: Thank you, Phil.

Today MKS announced record company in ALM revenues as well as the return to overall profitability.

It was encouraging to see another solid performance in ALM licensing particularly one without any one key transaction contributing more than 250,000 in license revenue.

This demonstrates our ability to drive consistent revenue from our account base, and we are encouraged by the repeat business with our customers, which represented 80% of sales in the quarter.

Our sales efforts, however, are also focused on some much larger opportunities with key major accounts. Some of these initiatives are with new targets, but most represent long-term initiatives to roll out new capabilities or to new divisions within the existing customers.

We continue to limit headcount consistent with our commitment to higher levels of profitability had had an ending headcount of 303, a decline of 6% from the equivalent period of fiscal 2007.

ALM sales headcount was 40, an increase of 1 over the prior quarter, but still 27% less than where we were at our peak in sales headcount in Q2 of fiscal 2007. This quarter showed a significant improvement in sales productivity of 71% from the year ago to $178,000 per rep.

Some of the key sales over the period included repeat wins at Continental, Fortis Bank, HSBC, IT Frontier, Torstar, Northrop Grumman, TietoEnator and Trading Technologies.

During the past quarter, we also signed up some exciting new account names, which included Chase Paymentech, ING Bank, Medtronic, Migaro and Professional Data Solutions.

Although (IO) experienced a modest decline in revenue to $1.8 million from both the prior quarter and the equivalent period last fiscal year, this segment had another solid profit performance with operating income of $0.4 million.

The stability of revenue in earnings from this group continues to be an important part of the MKS story even as the percentage of overall revenue that it represents continues to decline.

We believe that our services growth in building block of backlog - in building a backlog is a leading indicator for future license growth. Our customers are investing significantly in establishing an automated development processes to help provide them more visibility into their application development departments.

The bulk of the services revenue for MKS has been geared towards rapid and efficient deployment of MKS Integrity licenses to help ensure better chance of follow-on sales.

We continue to depend more and more in partners to drive services into customers as our key focus remains in selling and deploying software licenses into our targeted accounts.

During the quarter we joined Lockheed Martin at Gartner's IT XPO to present the way that global organizations can rapidly achieve large-scale adoption of software development maturity.

According to Dr. Jeffrey Phillips, Chief Technologist, Health Information Technology Solutions at Lockheed Martin, "Embedding Lockheed Martin's CMMI processes and best practices within an ALM platform enables a consistent monitoring of work performance during all stages of the development life cycle. This is critical to achieving CMMI Level 5 maturity benefit such as reducing code defects and product development and maintenance cost and increasing code re-use and product quality."

In summary, MKS Integrity is the platform of choice for improving and automating our software development process.

Other quarterly marketing efforts drove more than 10,000 leads into our sales organizations this quarter through a mixture of trade shows such as Gartner IT XPO mentioned earlier, as well as the online events, online advertising and focused regional activities and finally we made significant investments in search engine optimization this past quarter.

The launch of our improved capabilities for Requirements Management Integrity 2007 launch in July has driven significantly downstream activities and much more interest from customers' new target accounts and industry analyst firms.

Specific to our management of requirements' capabilities, we are pleased with our performance in a report issued by Forrester Research on requirements management (tooling), which named MKS Integrity as the only solution to score full marks across Forrester's six criteria for managing requirements.

Due in large part to MKS' paradigm shift in this key domain for managing software applications, 1/3 of the leads we collected in this quarter related to requirements management challenges. Increasingly, it has becoming more and more obvious that the quote market leaders offer little more than requirements authoring and do not address the real challenges of change control reuse and traceability through the development life cycle facing organizations around world.

MKS Integrity on the other hand solved these challenges head-on.

Our success towards selling and deploying software into global systems integrators continued in the quarter with follow-on deals to Lockheed Martin and TietoEnator, (an important for live stories) with Canonsoft and Mitsubishi Research DCS.

Increasingly, we are finding the high value add systems integrators can deliver to their customers, which includes streamlining their process of negotiating and a green business requirement, enabling their customers to review processes, controlling scope (unintelligible), viewing in real time the impact and project risk caused by change in requirements and boosting process maturity and certification levels.

All of these capabilities allow our customers, our systems integrator customers to develop more business with their end customers and manage what they have developed more closely.

Our expectations are that these systems integrators will not only continue to become deeper and broader customers of ours and MKS Integrity, but will also play a vital part in developing business between MKS and their end customers.

In summary, we had started the year with our fourth consecutive quarter of ALM revenue growth, our repeat business indicators are strong, our ALM maintenance growth points to satisfied customer base and we continue to work on developing larger and more strategic transactions to help drive targeted annual license sales growth.

Back to you, Phil.

Philip Deck: Thanks, Michael.

We traditionally seen about half of our revenue coming from engineering firms, that is, companies that are building software to be part of their product like electronic device firms, chip makers, software companies and systems integrators.

And about half from IT departments of non-technology companies, as they build software applications for internal use like banks, railways and government departments.

Over the past six quarters, we've seen a marked increase in our engineering focus customers, and we think there are a couple of important factors driving that trend.

First, our new capabilities for requirement management and in particular for artifact reuse capabilities have become critically important for engineering companies as they try to shorten product cycles by establishing better component reuse strategies.

The urgency of these initiatives is profound and the capabilities of MKS Integrity are uniquely suited to this challenge.

The second trend is among customers of all sizes where the ability to unify development activities is driving license deals as never before.

New MKS capabilities to address a very broad set of development processes in a highly integrated iterative way have enabled the companies to achieve a degree of collaborative efficiency that they could never do by using loosely connected point products.

And the third trend is among systems integrators who are working to better integrate their processes to those of their customers with more visibility in both directions. The systems integrators that we assigned in the past 18 months have many thousands of engineers who are beginning to roll out MKS integrity who in addition to being customers expose our product to their customers every day.

We continue to expect that ALM license revenue will improve in fiscal 2008 from the levels of fiscal 2007, which combined with continued increases and maintenance and service revenues will result in higher total revenue for fiscal year compared to fiscal 2007 more than offsetting expected declines in interoperability revenue.

We are managing our cost to sustain current sales and marketing capacity and expect to make further investment in sales resources only to the extent that profitability can be expected throughout our planning horizon.

We expect full-year profitability for fiscal 2008 based on increasing revenue and carefully managed costs.

We expect to maintain more than sufficient cash balances through fiscal 2008 through the combination of expected improvements in net income, reduced capital expenditures over those in fiscal 2007 and then expected continuation of lower overall receivable days net of current dividend policy.

We expect that seasonal factors will cause inflows of cash in the second half as our annual maintenance renewals are more heavily weighted to the last two quarters of the fiscal year.

Our board of directors yesterday approved our regular dividend of 2 cents per share US consisting with our policy to return cash not needed to fund growth to shareholders through our regular dividend.

The board of directors has a great deal of confidence in the soundness of our business plans, the opportunities at hand in our changing markets and our short-term plans for profitable growth.

We appreciate the support and confidence of all our shareholders and look forward to reporting on our progress in the months to come.

I would now be delighted to answer any questions from analysts.

Operator: Ladies and gentlemen, to register for a question, please press the 1 followed by the 4. You will hear a three-tone prompt (to acknowledge) your request.

If your had been answered and you would like to withdraw your registration, please press the 1 followed by the 3. If you're using a speakerphone, please lift your handset before entering your request.

One moment, please, for the first question.

Our first question comes from the line of Scott (Penne) of TD Newcrest.

Scott Penner: Thanks. (Penne), I like that.

The - I just wanted maybe talk first about the exchange rate impact on your expenses in the quarter, I guess, you know, sequentially versus Q1.

Philip Deck: So the total impact on expenses was about $640,000 and that was compared to about, you know what, an increase in Q1 of about $400,000. So those are incremental of course. They add on top of each other. So the net cost increased over the first two quarters was a little over $1 million.

Against that, we had a benefit in terms of revenue because we, of course, have euro and pound revenue and maintenance revenue from those two currencies of about $600,000.

And then, this quarter we also had a bit of a more unusual gain just on the value of cash held in our non-US bank accounts of around 300,000. But the ongoing change, if you like, is almost 1.1 million in cost and about 600,000 in revenue.

Scott Penner: Okay. So that would, you know…

Philip Deck: Sorry, revenue in the positive sense.

Scott Penner: Right. So net about half million?

Philip Deck: Yeah.

Scott Penner: Okay. And the - at the annual, Phil, you've shown a couple of slides. One of them indicating the retrenchment in license revenue from your top 20 or 25 customers accounting for pretty much all of the drop in license revenue this year.

And then, you know, in Q1 now that number from again, those customers really bounced back to both 2.2 million. What is the number consistent on that basis for Q2 and then, any current perspective on what those large customers are doing right now?

Philip Deck: In Q2 we didn't have a great performance in dollar terms from those companies, although, we did do quite a few deals. In fact, the whole second quarter was a matter of doing in some ways much smaller deals than we expected but from quite a large number of customers both new customers and existing customers.

So, you know, I guess the perspective on large customers is, you know, in general that we're still working through a lot of the big projects…

Man: Uh-huh.

Philip Deck: …that we have with them. We're, in some cases, going through a fairly extended upgrade, in some cases over a couple of years of upgrade of our product in order for them to take advantage of some of the new capabilities.

And then fortunately that in some ways because we've made quite a few, I would say, infrastructure changes within the product, you know, there's new Web server and, you know, over the last couple of years we've been really encouraging people to go to our database back end and we've been encouraging people to move on to somewhat more scalable servers.

So in some cases, the upgrade (path) for some of our existing customers is quite lengthy and they test the various - have to go through a lot of testing of the various components before the upgrade.

So we're still working through a lot of that. This quarter we didn't have a huge amount of production from those companies. In fact it was less than a million in licenses versus, I think, we did about two last quarter.

But, you know, we're still - I guess a lot of the projects that we've been working on for a long time, we're still pretty excited about and are maturing (fairly) steadily.

Scott Penner: Okay. And the perspective on what you're doing in the package application space, (I mean), you could just update on what exactly is shipping today and then any metrics around either a customer or SI adoption?

Philip Deck: Well we're still very much in - kind of an early adaptor program on that. I think when we talk about it a while ago over the last couple of quarters, we talked about being in an early adaptor program where, you know, a handful of customers are using it on a - kind of - or deploying on a trial basis as we finalize it.

So, that capability is not really (DA) at this point, but we're probably not too far from that. I'm not sure if, Mike, if you have anything else then on that.

Michael Harris: Just that we're further along with the SAP over the Oracle piece and that's being deployed in earnest right now in one of our key target accounts.

Scott Penner: Is that SAP functionality that is generally available today?

Philip Deck: No. It's still under the early adaptor program…

((Crosstalk))

Scott Penner: Okay.

Philip Deck: It's pretty mature in terms of its finished completion, a little bit more mature than the PeopleSoft one because the PeopleSoft is somewhat more complex than the way we have to go about it.

Scott Penner: Okay. And you both mentioned quite a bit on requirements management, what about the competitive environment in specific, I guess, first of all two requirements management with what's going on or not going on with the (Total Logic) merger, what are you - what are you seeing as far as the competitive landscape?

Philip Deck: Well I mean there's still a lot - only a handful of products that are around and, you know, in that traditional way, (Orlin) has one with (Caliber) and there's Telelogic DOORS. You know, those products had been around for a while, but I would say what's happening in the requirements management is that in area is that there's a real paradigm shift in the way companies want to use requirements management.

You know, it has traditionally been a document-centric kind of approach and people have wanted to produce requirement with somewhat more limited objectives in terms of how they could then, you know, manage the life cycle of individual requirements and do a reuse.

And really with the release of our platform that allowed you to do really sophisticated requirements reuse. We've seen a real search in activity among customers that have significant product cycle problem.

So, you know, when you make a product and you release it in sometimes dozens or even hundreds of different versions because of - either different versions of the product or different geographical areas you're selling it to or different customer requirements you're selling it into, then the advantages you can get from reusing the components, that is, having a group of components whether there are pieces of software, requirements or specifications or documentation that you, you know, generally evolve as a main product, but then can branch off and maintain variants of those artifacts to manage all the different products you try to sell into.

So in simplistic terms, you know, you have some requirement for a Bluetooth interface and it applies to a couple of dozen products going to 30 different countries. And that Bluetooth requirement may be slightly different for every country, and you have to maintain the requirement in a slightly different way, but be able to manage it efficiently and with high integrity, that is, make sure that people are actually using the right requirement for the right product and the right country.

That kind of activity is very hard to do with requirements management products in the older kind of style, in a document-centric style. You really have to approach it with the different kind of technology, one that allows you to do significant reuse of those components.

And that's what our product is able to do, and it's why we are engaged with so many large engineering firms and, you know, we do about half our business with engineering firms and half our business with IT firms as I mentioned, you know, almost all of the major engineering firms that we're looking at and - or working with and have been over time have an identical problem as it apply to component reuse and the need to share requirements and be able to manage their requirements in a more sophisticated way.

And that applies (down) (unintelligible) of requirements too, but it tends to start with requirements, where they have to start managing them to prove the customers that they're actually doing it right and that's where we have a lot of activity.

Now, implementing that kind of requirement reuse or component reuse strategy within a major engineering firm is a lot of effort. It's a lot of effort on the part of the customer to set up their processes and to organize their technology and decide how they're actually going to make it work, and it's a lot of effort on our part to actually configure the systems to match their internal process and their approach to it, but the opportunity is really incredible as far as we're concerned because the consistency of need is quite amazing where, you know, the way customers describe the problem that they have and the capability that they need to develop is amazingly consistent from, you know, embedded systems to electronic devices to chip makers, you know, people have the same idea that they want to consolidate the number of components they use and they want to reuse them.

And so - and that's really driving a lot of our progress in the engineering market this day and that's where a lot of the old style requirement management systems don't work very well.

So, you know, in terms of DOORS, you know, we have no idea what's going on with the merger. It's kind of behind the moon right now and at some point I guess, some of it will prove it.

And so we haven't seen much change in the landscape. But we're not of the opinion that it would be easy for them to really update their products to make them do what we're really doing with a lot of the engineering companies today. So we think our product is in a slightly different category than theirs.

Scott Penner: Okay, and that's - it's very helpful.

And just lastly maybe to extend that to a larger discussion on the environment, I mean, you've seen the results out of (unintelligible). I don't - look terribly well on the distributed side and (Borland) is looking at a pretty flat ALM business this year and rationale was down 1% on a constant currency basis last quarter. I'm just trying to get a sense of - given what seems to be the need for a lot of these products why we're just, you know, where you just don't seem to be seeing the revenue out of some the vendors you would expect.

Philip Deck: Well I love your list of news, a lot of it is news to me actually. So, you know, you'll have to supply me with more of the detail. But I would say that in general when you look at our business, you know, where compliance for instance was the significant driver two or three years ago, the urgency on compliance is definitely dropped. It has - certainly hasn't gone away, but people aren't afraid of going to jail, you know, they're trying to improve their compliance over time and realizing that really they should take a little more time and develop systems that are based on good productivity gains and good internal practice.

So I'd say the, you know, urgency to buy products is stronger right now on the engineering side than it is on the IT and of course there's tons of exception to that, but in general that's the case.

And we're being driven by, you know, frankly when we look at the reasons we're selling software in a lot of cases, it's for the features that we have that other people don't have and, you know, I suppose that's not surprising in a lot of product categories, but if people are really demanding sophisticated reuse, I think we're the only place you can go for that.

If people are looking for a real unified interdepartmental ability to collaborate together, I think we're the only people that can truly offer that so, you know, I think, we know why our business is going well, you know, obviously I don't understand other people's businesses too well.

Scott Penner: Okay thank you.

Operator: And again as a reminder, to register for a question, press the 1 followed by the 4.

Our next question comes from the line of Dave Taylor with GMP Securities. Please proceed with your question.

David Taylor: Hi guys, just one question. I was just hoping you could provide some insights to maybe your cash holding with respect to the recent meltdown, (I guess), with asset-backed commercial paper.

Man: We have no exposure to asset-backed commercial paper at all and all our cash holdings are held in, you know, treasury grade or very close to a security.

David Taylor: Okay great. Thank you.

Operator: Our next question comes from the line of (Danor) (unintelligible) with BMO Capital Markets. Please proceed with your question.

(Danor): Hi guys, good afternoon.

Great services margin on the quarter. I want to just drill up a deeper on that. Is that the question of the utilization rates going up?

Man: Absolutely. I think a couple of things, one, it was a quarter where we don't really - we didn't really have any significant holidays. That'll change a bit the next quarter, of course, because we have Thanksgiving and Christmas, but in the second quarter you have three pretty clean months for delivering services.

We have had growing backlogs for now three quarters of - in a significant way, so when you have a lot of projects that aren't necessarily, you know, don't have to be delivered exactly on a certain schedule and you can move them around a bit and schedule them a bit, then you gain a lot of efficiency.

People have been really working had in that area as well because it's an important area for driving license sales and every one knows that.

And, you know, as utilization rates go up then your margin goes up. So we might see a bit of a change in that in a very modest way in the next quarter just because we have a couple of weeks where it's hard to book services.

(Danor): Then you talk in the past about how you're using the consultants more and more for the services work, wouldn't that have an adverse impact on the margins going forward or no?

Man: No, the margin isn't significantly different when we use an outside consultant.

(Danor): Okay. And is a lot of the increase in work sort of related (to laying) the groundwork for future implementations? Is that kind of what's happening there?

Man: Well it's both. There's a lot of work just in - there's been a lot of work just deploying software that we've already sold, you know, sometimes we'll do a large license deal and then, you know, you might have a service to contract that's - say 50% the size of license deal that you deliver after the fact.

In a lot of cases we find, and in fact (unintelligible) this quarter, we're looking at a large license program, say someone needs $1 million worth of licenses, it's going to buy $100,000 worth of licenses, which is the amount they need for that actual implementation and because they don't really need the full license compliment for, you know, three or four, five months after that because all they're doing is doing the configuration and getting ready to do the roll out.

So, sometimes in that case the services we're delivering are ahead of the bulk of the license contract. It's not often that we do services without any kind of license deal, but it's - I supposed conceivable. They'd have to do a little bit.

So it's a bit of a mix. And so there are certainly lots of those services that are going to existing customers where we hope that the configuration we give them and the work that we do is going to lay the groundwork for another big license deal.

(Danor): Okay. On the expense side you mentioned the $300,000 currency gain, where there any one-time cost or gains of notes in the quarter?

Man: No. We hardly ever have those things, and it was an unusual circumstance where we just got so (panicked) with the dollar going up. We decided to buy some Canadian dollars before they got even more expensive.

(Danor): Okay.

And you had some good growth on the ALM side in, I guess, outside North America, can you (unintelligible) some color as to the breakout or I guess the - directionally Europe versus Asia-Pac really both strong or was it more (suited) with one?

Man: Michael?

Michael Harris: I think the year-on-year growth was about the same between North America and the rest of the world. A small increase in rest of the world mainly due to some strength in Germany and the addition of Asia-Pacific, which (really didn't) contribute anything in the last quarter.

So, you know, our North American license sales had been relatively flat over the last few quarters, with main - most of the services increase coming from North America partly to help shore up licenses going forward. But no, I would say mainly the increase is coming from international over the last year and over the last quarter.

(Danor): Okay. All right, thanks guys (unintelligible).

Man: Sure.

Operator: There are no further questions at this time. I will now turn the call back to you to continue with your presentation or closing remarks.

Man: Oh, I - sorry, I couldn't really understand what you said.

Well thank you very much. If there's no other questions, we'll end the call, and we look forward to reporting further in the months ahead.

Operator: Ladies and gentlemen, this concludes the conference call for today. We thank you for your participation and ask that you please disconnect your line.

END