

MKS INC

Moderator: Jennifer Lombardi
November 24, 2009
3:00 pm CT

Operator: Ladies and gentlemen thank you for standing by. Welcome to the MKS Fiscal Year 2010 Q2 Results conference call.

During the presentation all participants will be in a listen only mode. Afterwards we will conduct a 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 simply press the star followed by the 0.

As a reminder this conference is being recorded Tuesday, November 24, 2009.

I would now like to turn the conference over to Phillip Deck, Executive Chairman. Please go ahead sir.

Phillip Deck: Good afternoon and welcome to the MKS Second Quarter 2010 conference call. I'm here with Michael Harris, our President and CEO and Doug Sawatzky, our Chief Financial Officer.

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

Larry Wasylshyn: 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 depend upon or refer to 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 filings with Canadian securities regulators.

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

I'll now turn the call back to Phil.

Phillip Deck: Thanks Larry. Today MKS reported financial results for our second quarter ended October 31, 2009. We reported overall revenue of \$15 million and pretax profits of \$2 million.

Compared to the second quarter of 2009, the last quarter before the effects of the recession took hold, our revenue was lower by 10% but pretax profits were higher by 12%.

Our license revenue was approximately \$3 million, down from the \$5 million we recorded before the onset of the recession.

We experienced sharp reductions in license revenue in the late fall of 2008 as customers in the automotive, manufacturing, and banking sectors in particular made drastic reductions in capital spending. The reductions in demand were acute in the past four quarters with the exception of a large transaction in the first quarter of fiscal 2010.

Maintenance revenue has continued to grow steadily though this period as customers have largely kept current on maintenance and services have grown as customers continue to engage us to deploy licenses they have purchased already and those they intend to purchase as economic conditions improve.

Our closing cash balance at October 31, 2009 was \$19 million, a \$2 million increase from the \$17 million balance at April 30, 2009, and down approximately \$1 million from the end of last quarter.

We have now reached this normal seasonal low point for cash as we typically build cash over the last two quarters of the year due to seasonal maintenance renewals. During the quarter we also paid \$1.3 million in dividends.

I'd now like, to go to Michael Harris, the CEO of MKS for an update on our business.

Michael Harris: Thanks Phil. We're pleased to report another solidly profitable quarter based on strength in ALM services and maintenance, as well as lower costs. Our licensing revenues showed some signs of improvement with somewhat better performance within small and medium size transactions but still showed the effects of the recession as a whole.

Although the capital budget of our most important customers remain constrained, we have made a great deal of progress over the same 12 months as we continue to win new and promising accounts by demonstrating our understanding of the software development challenges and showing how MKS Integrity and our teams can uniquely solve them.

The pace of improvement in customer activity, their spending on services engagements to prepare for future rollouts, the prospects for renewed capital budgets in the beginning of calendar year 2010, and our increasingly opportune corporate cost structure have all contributed to our decision to make new investments in sales and services headcount in order to capture the opportunity ahead of us.

Some of the key follow on license fields which most recently demonstrated our customers' commitment to MKS Integrity came from Denso, ITT, Magna, MCR, Northrop Grumman, Research in Motion, Safe Net, Teva Pharmaceuticals, and Verizon Wireless, among others.

None of the license transactions were of large size this past quarter with only two greater than \$200,000. But many of our customers continue to make investments in much larger future implementations.

Our IO team contributed significantly to the overall results again this quarter with a couple of important wins in some long term strategic accounts. As business declines we have steadily moved members of the IO team to our ALM business including most recently the head of marketing, Wendy Williams, to help drive demand within the ALM market.

Their experience with some of the top engineering companies in the world is proving to be an invaluable resource as we further develop our ALM business.

Turning back to the ALM business, our professional services or ALM related consulting revenue continues to grow at its steady historical pace, this past quarter finishing at \$3 million.

The growth over the last couple of years has been mainly the result of longer engagements rather than a larger number of individual projects. As the size of our customers and target customers increases so does the size of their service engagements.

Our MKS Integrity platform has become the platform of choice for the most complex and demanding software engineering challenges and has seen vast improvement in its capabilities over the past few years.

But the real capabilities of MKS Integrity come to life when combined with the increasing experience of our field engineering team. These teams have deployed it throughout some key vertical markets where our knowledge of best practices, the specific business problems that are most critical for those businesses, and our ability to coordinate the migration from a patchwork of point products to the engineering platform of the future shines through.

Still, for MKS services are a means to an end. The right amount of services produces the best implementation which in turn leads to the best return on investment for the customers and yields the most rapid investment in new licenses. Our services directly drive customer success and this customer success is the most direct route to success for MKS as a whole.

We are adding steadily to our team of customer solution engineers or CSEs in order to manage the increasing pace of evaluation, solution development, piloting, and implementation activity that we're experiencing.

Going forward we expect to see a higher proportion of CSEs in the company as we work more closely with our most strategic accounts.

Finally we'll also continue to depend on our strategic service partners as an essential part of our overall delivery and will leverage them as needed while we grow this important part of the revenue of MKS.

The most encouraging progress we have seen over the past year is our increasing ability to win global ALM mandates. We are focusing our efforts more than ever before on a smaller number of larger and more lucrative accounts.

This renewed focus means getting immersed in their business challenges around the production of software to solve business problems that are the most critical to their abilities to develop software faster, release it better, and maintain it more effectively.

This focus has resulted in winning some key global mandates where we can see a path to expanding small current installations to enterprise wide deployment. These global mandates clearly take a great amount of focus and

effort to achieve and once they have been won they can offer significant rewards.

Important to note is that these mandates are becoming more ALM wide projects as opposed to within any one of the domains of software engineering such as requirement management or defect management.

While these cross disciplined sales involve more effort as they involve far more constituents from the customers, the value comes when the customers start to see the real value of the platform and that they can build on MKS Integrity for all of their software engineering needs.

In summary, more and more the market is accepting the notion that to truly automate the software development process in a manner which increases capacity and quality, enterprises must look at the bigger picture across all aspects of software engineering. Our mission has always been to be the leader in this market and our persistence and focus on this message has paid off.

Over the past two years we have seen a consistent increase in demand from companies that build software to include in their products. The amounts and complexity of software on each of these devices whether they be automobiles, smart phones, or medical equipment, is simply becoming too overwhelming to manage the software engineering resources alone.

Combining this increase in the amount of software with the shortening lifecycle for products in the market today and intense competition is creating tremendous change in the way these companies operate and deliver products to their customers.

Global technology organizations are addressing this challenge by looking to better improve their processes as well as the overall automation of their software development process.

While the power of intelligent ALM solutions is still valid for the market at large we are seeing much more adoption of cross discipline ALM in organizations where managing the overall - overwhelming complexity of software across dozens or hundreds of products is simply too expensive not to automate.

One of our newest customers, Intuitive Surgical which has recently deployed MKS Integrity, has done so to address specific challenges in software change management. They're working in an environment where even small changes to the software code which resides on their robotically assisted surgical devices must comply with hundreds of detailed regulations which has created massive overhead for the engineering team.

This compliance can now be achieved automatically thereby minimizing the chance of human error while making the overall development process far more efficient

This is just one example of the type of complexity that can be automated by using MKS Integrity within a software - embedded software development environment.

After four quarters of stable headcount we have been starting to make new investments in targeted sales and field engineering. Our sales rep headcount ended the quarter at 30 and we expect to be at 35 by the end of the fiscal year.

By then we will be at the highest level in two years. We continue to hire sales teams in the areas where we see high concentration of software engineers, hiring with specific accounts and vertical industries as the target.

We're also looking to further increase the size of the customer solution engineering, or CSE teams, in proportion to the sales reps themselves. As I mentioned before these CSEs are the ones who are working most directly with our customers to ensure that our customers buy, get deployed as effectively as possible.

Over the back half of the year we expect to reap the rewards for much of the work that we've put in to win some key global accounts - some key global mandates. Many of our key customers have spent much of 2009 readying themselves for further deployment of MKS Integrity by finalizing various solutions which are now ready for implementation.

In short, after a year of successful account penetration we see the signs of life in license deployment and are adding staff to handle what we believe will be a return to growth.

I'll now turn it back to Phil.

Phillip Deck: Thanks Michael.

I'm delighted to tell to that at our board meeting yesterday Michael Harris was appointed CEO of MKS. Michael has been with MKS for eight years and we together have created what I believe to one of the best positioned companies for growth in the software industry today. Our partnership has been extremely productive and has evolved to meet the challenges and opportunities that face us.

My years working with Michael give me great confidence in his leadership as CEO of the organization into which I've poured so much of my energy and financial capital into one in which I will continue to work fulltime as Executive Chairman.

As Executive Chairman, I will spend more of my time in the external aspects of our strategy while creating more clarity in the chain of command internally. I will continue to work full time with Michael on the strategic aspects of our strategy, shareholder relations, financial issues, and working to cultivate external partners and allies. Most of all, I'll be supporting Michael in building MKS into the world leader into which I believe we are destined to be.

Our increasing focus in embedded systems gives us the opportunity to focus and specialize as never before. It's only now that we have the products, the proven customer success, and the right competitive dynamics that we can really double down on that approach to customers that can create so much value for them and for us.

In the process, we have the potential to grow at a much higher rate than we have ever done to date. As the largest shareholder of MKS I truly believe that our greatest success still lies ahead.

Through this past year, we have successfully guided MKS through the recession, while steadily building profits and shareholder returns. While the recession caused our license revenue growth to pause, we have put the period of turmoil to great use by focusing on the customers that can best deliver license growth in the future.

We also took steps to safeguard the company from the turbulence of the worldwide currency markets and as a result now enjoy two years of cost advantage and cost certainty through our currency hedging program.

We will use this advantage as well as - as well in the service of our long term strategy in funding the investments we need to make to return to growth.

At the cores of our strategy lies our commitment to profitable growth and the maintenance of the right balance between the two. Consistent with our policy to return cash not required to fund the growth of our business to shareholders, we were delighted to announce an increase in our regular dividend from 12-1/2 cents a share US to 15 cents a share.

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

We would now be pleased to take questions from analysts.

Operator: Ladies and gentlemen if you'd like to register a question please press the 1 followed by the 4. You will hear a three tone prompt to acknowledge your request.

If your question has been answered and you'd 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.

Once again ladies and gentlemen to register for a question please press the 1 followed by the 4 now.

One moment please for our first question.

Our first question comes from the line of (Tom Liston), (Reverson) Partners.
Please proceed with your question.

(Tom Liston): Hi, thank you. Good afternoon. And congrats Michael on the promotion.

Just a lot of commentary in the MDA and the presentation and prepared remarks about winning the number of major new mandates I think it was praised as. And obviously they haven't quite locked the actual spending on licenses.

So can you walk us through as much as possible why you feel - and it looks like you're investing obviously some sales resources to open this up. Is it mainly about budget? Is it maybe somewhat about viewing you're as more strategic - maybe they felt you're looking at a requirement management type proposal and seeing that maybe you're more strategic whether it's adding features or strategic that you could scale on a global basis.

And just where are you in that cycle where you feel - it seems like you feel a lot more confidence that budgets are going to be - are thawing at least a little bit here?

Phillip Deck: Well that's definitely a CEO question. Michael?

Michael Harris: Thank Phil. So, you know, the global mandates that we - that we're winning are mandates where we'll be deploying licenses we're guessing for years. And I think that there's probably two, three reasons why we're starting to win these mandates.

You know, as you suggest (Tom) we've completely rounded out the product now. So, you know, we would always talk about the fact that we can deliver ALM who didn't really have such a great story for this on the test management side and now we do.

I think the second reason would be the fact that we've got a lot more reference accounts now. So we would be talking to these large accounts and they would say, "Well, you know, show me where you've got this whole ALM end to end Integrity deployed."

And we were able to show domain specific implementations on large scale but we didn't have that many customers who deployed it end to end and we've had a lot of success with, you know, Continental and MCR and some other customers primarily in Europe the we're now harvesting and bringing that back to the US.

And I think the last reason why we're winning these is our intense focus on these verticals. There's a tremendous amount of domain specific or vertical specific expertise in software development that we're able to bring from our current customer base and apply it to our other targeted customers in those verticals.

And why we feel that these - that the capital's starting to thaw a little bit is the fact that they are investing significantly in services in preparation for further deployment. So over the last couple of years our services dollars as a percentage of our services fees and percentage of license fees has been growing to the point where in a lot of these large accounts we're selling as many services as we are licenses.

And so a lot of these customers have basically stopped buying in 2009; have got now budgets for 2010 that we didn't see last year. But the fact is they've been investing services to configure the software and do the various different integrations and really get ready for the deployment.

(Tom Liston): So in other words they're well down the path in designing this out.

Michael Harris: They're well down the path and they're anywhere from, you know, very, very, very small minute implementations to they're really underway. And those are the customers that, you know, they still always see obviously always competitive threats but we have a lot of momentum in these accounts where we've got the mandate.

(Tom Liston): Okay and just - and I think you basically said in the remarks that the sales resources and such that you're hiring is it mainly with vertical expertise or is it more on a geographic expansion to Asia or is it perhaps a mix of both? Where is the core focus there?

Michael Harris: Well you know, more and more with our focus on the key embedded customers we're hiring people specific to accounts or verticals more than territories.

That being said three of the last four reps that we've hired on the California area - well happen to be in the California area but they're focused a lot more on, you know, they have expertise with automotive or they have expertise with medical devices.

We've hired a sales team in the UK just recently actually where this person's been selling only into the aerospace business for the last ten years. And then

we've also hired an application engineer who's built solutions in one of our customers the last 15 years.

So that's the team that we're going to say okay here's your six customers, your six target accounts that we must get in, you know, go and figure a way to get into, you know, X number of these over the next couple of years.

So this focus allows us to say these are the accounts that we want to be in, these are the reasons why. Now, you know, who's the right person to go and do that? As opposed to I think where we hired maybe a few years ago where we were more interested in general enterprise software expertise as becoming more tailored to the customers' vertical.

(Tom Liston): Sure, makes sense. And just finally - apologize if I missed it - did you talk about the BMC relationship how that's developed? Any more activity there?

Michael Harris: We didn't talk about the BMC relationship and we've got - there were no transactions - no significant transactions in the quarter with BMC.

We're developing a bit of a niche with them in some federal government opportunities in the US. And we've got a half a dozen opportunities that we're working on. But it hasn't been - it hasn't progressed significantly. I think we've said last quarter that we didn't expect any business in the second quarter and we don't expect anything significant in this quarter but there are a couple of things that are starting to brew.

And we actually got some follow on business from one of the more key transactions that we did with them in the first quarter. So it's starting to pay off but it's taking some time.

(Tom Liston): Great, thanks. I'll pass the line.

Operator: Ladies and gentlemen as a reminder to register for a question please press the 1 followed by the 4.

One moment please for our next question.

And Mr. Deck there appears to be no further questions at this time. I'll turn the call back to you. Please continue with your presentation or closing remarks.

Phillip Deck: Great well I appreciate everyone dialing into the call today and we look forward to talking more about our progress in the months ahead. Thank you very much.

Operator: Ladies and gentlemen that does conclude today's conference call. We thank you for your participation and ask that you please disconnect your lines.

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