

MKS

**Moderator: Phillip Deck
February 24, 2009
5:00 pm CT**

Operator: Ladies and gentlemen, thank you for standing by and welcome to the MKS Fiscal Year 2009 Q3 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, please press the star followed by the 0.

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

I would now like to turn the conference over to Mr. Phillip Deck, Chairperson and CEO. Please proceed.

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

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

Larry Wasylshyn: Thanks Phil. 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 expect, anticipates, intends, plans, believes, estimates or similar expression are forward-looking statement 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 statements due to, among others, those factors set out in MKS' 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.

Back to you, Phil.

Phillip Deck: Thanks Larry.

Today MKS reported financial results for our fiscal quarter ended January 31, 2009. We were satisfied with our performance, given both the challenging environment that we're operating under and the lack of any significant sized license transactions closing during the quarter.

Similar to the third quarter of fiscal 2008, licensing this past quarter was below our overall trend rates due primarily to normal quarter-to-quarter variability.

We grew all other categories of revenue, however, relative to the same quarter last year and boosted profits substantially.

Our services continued to show strength as we worked to implementing increasingly large scale implementations of MKS Integrity. As expected, our services revenue declined over the immediately preceding quarter due to the holiday shutdowns at customers.

Our backlog eased slightly due to the low level of new license activity but remains at a healthy level of about two quarters of service deliveries.

ALM maintenance grew about - grew 8% over the same period last year and at normal rates in local currencies, but due to large devaluation of the pound and euro, this quarter decreased modestly in U.S. dollar terms from Q2 of this year.

ALM maintenance renewal rates were unchanged from historical norms. We have seen no impact from the turbulence in the economy on maintenance renewals to date.

Trade receivables declined for the second quarter in a row from the unusually high level that we reached at the end of fiscal 2008. Our day sales outstanding at the quarter end was 61 days.

Our receivables balance continued to remain solid with no concerns about collectibility.

Closing cash balance at January 31, 2009, was \$16.3 million, up \$5.7 million from the \$10.6 million at October 31, 2008. Our strong cash generation was due primarily to the collection of some long-term receivables and an unusually strong level of collections of maintenance receivables at the quarter.

The renewal dates on maintenance contracts are not spread evenly over the year. The largest proportion falls late in the third quarter. Normally about half of the renewals due in the third quarter have not been collected by January 31 and remain as trade receivables.

This quarter we continue to enjoy our highly - our high rate of maintenance contract renewals, but also collected a much larger proportion of them boosting our cash balance further.

We're encouraged by the strong performance of maintenance renewals in this quarter and believe that it reinforces the healthy nature of our customer base and the importance of MKS Integrity in their operations.

As the Canadian dollar began to fall over this summer, we put in place a hedging program to ensure that declines in the dollar could be extended through our planning horizon to build stability in our operations and results.

We did not foresee the magnitude or rate of decline and consequently the hedges that we put in place has flowed the realization of the significant cost advantages that the lower Canadian dollar offers.

In the quarter just completed, our Canadian dollar cost averaged 93 cents, U.S., about 15% higher than they would cost at today's rates.

We remain committed to the hedge program, which extends through the third quarter of next year at prices more recently around 79 cents. These forward purchases ensure that the cost of our Canadian dollar spending will decline steadily through most of next year, providing some measure of stability and certainty in a climate where those things are hard to find.

The declining cost of Canadian dollar expenses that we have now locked in place can provide steady declines in operating costs through the foreseeable future.

I'll now turn to Michael Harris for a review of Q3 operations.

Michael Harris: Thanks Phil. Although our ALM licensing results were modest, we're pleased to report another profitable quarter for the ALM Division and for MKS as a whole.

This is clearly a challenging time in which to sell software, but we made good progress on several projects in this quarter which resulted in the overall positive performance of a profitable quarter.

Our largest single license transaction for the quarter came from one of our long term customers at \$400,000. In fact, most of our sales came from existing accounts with repeats wins with customers such as Abbott Laboratories,

Magna Electronics, Northrop Grumman, Royal Bank of Canada, Verizon Wireless, Vertex Pharmaceuticals and Wincor Nixdorf.

These wins, and other likely follow-on projects, show that we still have significantly more value to bring our customers as further opportunities for MKS Integrity to percolate into the user base unfolds.

Our IO team had another solid quarter with revenue of \$1.6 million, down 8% from the same period last year, an earnings of \$300,000. The consistent performance of this group continues to allow us to better plan for future investments within the ALM sector.

We continue to manage headcount and other operating costs carefully across all departments. We finished the quarter with 314 headcount, a 2% increase over the October 31 closing headcount of 308.

Our ALM sales headcount finished the quarter at 33, a decline of 4 from the same period last year and a decline of 2 from the end of the third quarter - sorry, at the end of the second quarter of 2009.

Even in the face of a small decline on year-on-year ALM licensing, the per rep sales productivity increased over the same period from last year to \$183,000 from \$151,000 per rep.

We are planning to keep the same sales rep headcount of 33 relatively flat over the coming quarters with some possible investment in particular geographies which are showing particular promise within our key focused account types such as embedded systems companies and other engineering focused companies.

Our year-on-year ALM services growth continues to be strong with a 21% increase over the third quarter of fiscal 2008 to \$2.5 million.

As with the annual growth in the past few quarters, the services revenue increase has more to do with the size of our larger services engagements than it does with a number of engagements that we're taking on at any one time.

These larger implementation projects not only allow us to dig into these engagements to unleash the power of MKS Integrity, but they also typically allow for more cost effective delivery of services with high concentrations of software engineers 100% billable over longer periods of time.

As in the past, we continue to call upon various partners around the world to help us fill in when we don't have the internal resources or capacity that we need to fulfill our obligations.

The next release of MKS Integrity is expected to ship in May of 2009; bringing to market our much anticipated events test management capabilities.

In December we began installing the beta version into some of our customers in order to solicit their feedback. Many of these customers participated in the design of these capabilities and the first reactions have been as expected; quite positive.

There appears to be a large market for us within a relatively large percentage of the global engineering companies, which to this date have been far too focused on manually managing their software testing.

Using spreadsheets and other such documents to manage and reuse effectively, the seemingly endless configuration of test artifacts is becoming exponentially more difficult as the overall complexity of softer assets grows.

We're comfortable with our year-to-date results, showing continued growth in revenue and significant gains in operating income. Many of our existing customers are engaged in long-term product rollouts and the majority of business this quarter came from the additions to their license seats as they continue to deploy more licenses of MKS Integrity.

We expect this repeat business trend to continue, however, we are also working on some very substantial new customer wins within Global Accounts.

So these new prospective customers that develop software to place on electronic devices such as automobile parts, medical devices and mobile phones, the increase in overall software complexity is (daunting).

It is with these embedded software customers and targets that we see the most promise for overall growth and we're working on several multi-million dollar projects that continue to move toward completion in spite of the turmoil in the rest of the economy.

While contracts of that size will not close every quarter or necessarily all at once, we continue to make excellent progress and are confident that they will add substantially to our license results in the near term.

For the coming quarter, we will continue to focus on deploying as much software into our customer base as possible, find new and strategic customer

wins, introduce MKS Integrity of 2009 to an inherently welcoming market and closely control our expenses.

We're looking forward to a strong year and finish while we plan for fiscal year 2010.

Back to you, Phil.

Phillip Deck: Thanks Michael. As Michael mentioned, we're now closing in on the very long awaited release of MKS Integrity 2009; almost two years in development.

And it will show that 2009 release is packed with improvements ranging from major advances and scalability and performance, new integrations through both the Eclipse and Visual Studio development environments and a major rebuilding of our Web interface.

All of these will provide substantial customer benefit and most are the result of strong user feedback and close cooperation with our major customers.

But what will be most significant in the improvement of our competitive position and the opening up of new license opportunities is the inclusion of what we think will be the market-leading test management capabilities that it will contain.

We will be releasing the market's only enterprise class test management capabilities built within an enterprise ALM platform.

Test management capability is the third and last remaining software - major software development discipline to be included within MKS Integrity, in

addition to the software configuration and requirements management disciplines in which we have already taken a technology leadership position.

Test management is the other side of the coin in many respects to requirements management. Once you create a requirement, you need to test against that requirement.

Virtually all of our requirements management customers have been asking for and waiting for this capability and our most immediate market will come within our own customer base. But that will just be the start.

We will now have the most complete ALM offering in the world built on an enterprise platform, built within a single unified data model. This unmatched capability in the world takes us to an entirely new level in our ability to satisfy the needs of major enterprise customers.

At the same time, we're completing the last major segment of our product offering. We're working hard to broaden our access to enterprise customers.

We continue to work with other enterprise software vendors in the product life cycle market, the service management market, the product portfolio market and others where the integration with enterprise class ALM capability can be a competitive advantage in marketing their products.

Our company is performing well under the current economic climate. Some sectors, like the automotive parts and banking sectors that have provided robust new licensing opportunities even six months ago, have become extremely challenging.

On the other hand, many sectors, like electronics, medical devices and healthcare remain healthier. Many of those can benefit significantly from the advantages that MKS Integrity can bring in improving time-to-market cycles and lowering the cost and risk of software development.

On balance, the mix of opportunities has changed, but we're responding to the market and finding ways to build pipeline and close license transactions.

We have grown our revenue and profit to date in fiscal 2009 driven by the positive performance of our primary operating segment ALM.

During the quarter, we did not see any deterioration in our historical maintenance renewal rate which remains at over 90%. Service revenue continues to grow and service backlog remains stable.

While our license pipeline growth has slowed due to the economic uncertainties faced by our customers, we believe that the level of licensing in the third quarter of fiscal 2009 was primarily attributable to normal quarter-to-quarter variability in major transactions, as it was since the third quarter of fiscal 2008, rather than deterioration in ongoing licensed opportunities.

We expect the license revenue, total revenue and income from operations will be higher in the fourth quarter of fiscal 2009 compared with the third quarter of fiscal 2009.

We expect a continued decline in the interoperability business of approximately 10% annually.

MKS recorded growing operating profits and cash flow through the first nine months of this fiscal year. We maintain a policy to pay quarterly dividends to limit the accumulation of cash excess to the needs of our business.

We continue to be enthusiastic about our dividend policy and our Board of Directors yesterday approved our regular dividend of 2 cents U.S. per share.

As our cash builds through its seasonal cycle and as we realize the benefits of the lower Canadian dollar and our cost structure, we look forward to reevaluating our dividend level in light of those benefits.

We also continue to believe that our shares represent excellent value at current levels. Although we did not make any purchases of our shares in the third quarter, we expect to resume purchases in the open market under its terms.

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

I will now be pleased to answer any questions from analysts.

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

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

One moment please for our first question.

And our first question comes from the line of Tom Liston from Versant Partners. Please proceed with your question.

Tom Liston: All right, thank you, and good afternoon. Michael, do you give a new versus existing customer as a percentage for the quarter?

Michael Harris: No, I don't. I mean, we don't typically measure that, and if we did, it would be based more on license revenues. Doug, do you have any of that information?

Doug Sawatzky: No, no. It's...

Tom Liston: The comment - it was mainly - sorry, it was mainly existing customers, though, that drove the quarter?

Michael Harris: Yes.

Phillip Deck: The majority was.

Michael Harris: Yeah, it was higher than normal current customer.

Tom Liston: Okay, and a very long-winded question, but Phil, can you comment; Q3 is often seasonally a little weaker, especially with what's going on out there, can you talk about your close rates?

Can you talk about any potential effect on while customers typically don't wait for the new release, per se, because they get a free upgrade, in this case, you're obviously introducing a very significant upgrade with the test piece -- do you think that might have caused delay - some delays and just any other

factors in the quarter that you might have saw some weakness in the - or maybe it's even just from the last two quarters being strong?

So you can comment on all those factors and walk us through, you know, where this quarter should go?

Phillip Deck: Yeah, to (unintelligible) but I'm sure it had nothing to do with our upcoming release. I mean, we show the new release to people, but there's no particular importance to when customers close because they get the upgrade anyway and - so that's unlikely to ever be much of a factor in it. So it wasn't that.

I mean, we're - we have a certain pace of small deals. Typically, you know, under \$100,000 represent around 2 million, 2-1/2 million, and that continued to be the case this year.

So we didn't see much deterioration there. We just didn't have many big deals, and, you know, typically the big deals; they're lumpy, we're working on quite a few of them, usually at least one lands in a quarter and this quarter none landed, so, you know, and that causes a more modest level.

Certainly some of the big deals, I mean, you know, if you look at the top 12 deals we've been working on this year, I would say a couple of them have disappeared due to the economic downturn, but I would say that the large majority have not.

And the large majority are from companies where that the timing at which they decide to buy software is not primarily driven by what's going on. Some might be a little bit smaller because of it, but essentially the initiatives are going on in spite of and somewhat apart from the economic problems that we all know about.

So I think it's basically lumpiness. When we look at our overall long-term license pipeline, we don't see any kind of deterioration like that.

So it - and this is - it reminds us very much of last year's third quarter where basically it was the same situation. We had a pretty decent level of small deals. We had a fairly average number of medium size deals, but we just had nothing big for that quarter.

Whether that's always the case in the third quarter, I don't know, this is kind of the third reasonably weak third quarter in a row, but I'm not sure that that's really a trend. It's just worked out that way.

Tom Liston: And anything along the lines or any of the customers starting to look at what IBM is doing with the Jazz launch, if you will, and maybe start to take a peak at that, or do you see much of them versus what you've seen in the past?

Phillip Deck: I think certainly Jazz is making an impact in terms of people talking about it in the market. They - you know, probably the best reaction I've heard and the one closest to where a lot of commentary that I've heard is, it's kind of a description that if you have enough money and enough time and enough services, you can make that work. But you better have all three of those.

And, you know, it's priced expensively, it's kind of an ambitious thing to achieve within all the different rational tools you have, you're probably going to do a lot of work trying to integrate the various parts together.

And I suppose from IBM's point of view that's all good news because they have an army of services people to help you do that. But we think that, you know, a better way is to use an architecture that starts off pretty elegant and,

you know, kind of seamlessly unified and you don't have to hire the army to help you install it.

Tom Liston: Okay. And some of the details maybe in one of the filings, but can you help us with your hedges and where your cost structures should start to shake out over the next coming quarters as you put in these hedges?

Phillip Deck: I will hand that over to Doug and he will tell you what the expectation is for our average Canadian currency over the next four quarters, which is what we have nailed down.

Doug Sawatzky: Yeah, so, right now we currently hedge over approximately 75% of our Canadian dollar cost and as Phil mentioned, we're hedged out through then end of our third quarter for fiscal 2010.

So the rates that we've got for the hedges coming up in the Q4 we're at 95 cents, in Q1 we dropped to 94 cents and in Q2 is where we start really seeing the benefits at 83 cents and Q3 of fiscal 2010 we dropped to 79 cents.

Tom Liston: Great, and 75% of your Canadian dollar cost which are what? Is it half your cost or - I forgot the number?

Doug Sawatzky: A third of our cost.

Tom Liston: A third of cost. Okay, good. Okay, thanks. I'll pass the line.

Phillip Deck: Thanks Tom.

Operator: And our next question is from the line of Scott Penner with TD Newcrest, please proceed with your question.

Scott Penner: Thanks. Phil, can you just go over again what you said about the maintenance revenue and the currency impact at the beginning? I just missed that.

Phillip Deck: So we renewed out maintenance - I mean, the third quarter is our biggest quarter for maintenance renewals, partly because it's calendar yearend. And so Doug, what percentage of - would it be around 35% of our maintenances in the third quarter?

Doug Sawatzky: Yeah - well to - it's the back half. We do about 2/3 of our maintenance renewals in the back half of our fiscal year.

Phillip Deck: Right, so there's a big lump of it. The renewal rate was quite high, as it normally is around 91% and that was - that's virtually unchanged from, you know, the quarterly trend that we have.

We just happened to collect a lot more of them during the quarter which surged our cash.

In terms of revenue, the revenue was sequentially down from the second quarter because the euro and pound came down. So the maintenance revenue that we have denominated in euros and pounds showed up in lower amount of U.S. dollars.

Scott Penner: Okay. And judging by your comments, I assume there wasn't really any surprises as far as the linearity of license deals in the quarter?

Phillip Deck: Sorry, the linearity?

Scott Penner: Yeah, you know, how many were signed the first month versus the latter two.

Phillip Deck: Oh...

Michael Harris: When they fell? They actually fell pretty normal.

Phillip Deck: Pretty normal. Usually when we have - usually the big deals come closer to the end and we didn't have any of those, so it was - yeah, pretty standard pacing.

Scott Penner: And Phil, when you say that you're confident that revenue will be up in the fourth quarter -- does that have to do with some of these large deals being far enough in the - far enough along the pipeline that you feel confident you're going to land a couple of them?

Phillip Deck: Yes. And I would say that, you know, compared to last year at this time -- of course last year we had one very large deal in the fourth quarter, as well as some, you know, one other fairly large one -- we're not nearly dependent on a single transaction in our pipeline this quarter as we were last year, but it's pretty robust.

And, you know, a lot of the large deals we've been working on, they are getting close to the end.

Scott Penner: Okay. And you mentioned the services backlog and you had about two quarters worth, I think is what you said. Does that mean that the services revenue that we see should stay, you know, relatively constant over at least the near term?

Phillip Deck: Yeah, that would be a logical conclusion.

Scott Penner: Okay. The delivery date of MKS Integrity, I had it in my notes that it was going to be April. Is May a change at all from the previous plan?

Phillip Deck: It's probably a couple of weeks of conservatism in that and the date isn't absolutely fixed in stone at this point.

Scott Penner: Okay. And just one other question would be about the large deal or deals that you had in Q4 of last year. Are the services related to this, are they - I assume that's part - still part of the strong services and still part of the strong backlog, is that anywhere near coming to an end?

Phillip Deck: Michael?

Michael Harris: No, not really. Of the two large deals in Q4 of last year, yeah, we've driven quite a bit of services from both of those and those will continue at least through calendar 2009 and one of them much, much beyond that, as well. So I would - and we've added some bigger services contracts, as well.

I would expect to see the same kind of level over the next couple of quarters anyway.

Scott Penner: Okay. That's all. Thank you.

Operator: And ladies and gentlemen, as a reminder, to register a question, you may press the 1 and the 4 on your telephone.

Our next question is from the line of Thanos Moschopoulos from BMO Capital Markets. Please proceed with your question.

Thanos Moschopoulos: Good afternoon. On the operating expense front, just curious as to why we saw a slight increase in R&D and G&A relative to Q2 when the currency would have been more favorable.

Phillip Deck: I don't have an immediate answer for you. Doug, can you...

Doug Sawatzky: Well, the one thing on that Thanos is the fact that the currency was favorable but we had already locked in the quarter's hedge rate at a higher rate than the current rates would dictate. So...

Thanos Moschopoulos: So - but in the MD&A you have the realized rate and I think it shows a slight improvement in Q3 versus Q2.

Doug Sawatzky: Yeah.

Thanos Moschopoulos: And then you would have benefited from the full impact of the euro and the pound right?

Doug Sawatzky: Right - well the euro and the pound don't really impact our development cost levels...

Phillip Deck: Or G&A.

Doug Sawatzky: Or G&A.

Thanos Moschopoulos: Okay. Okay, fair enough. And so that's why we saw the decline in sales and marketing especially is that's where you got the full benefit of the euro and the pound?

Doug Sawatzky: More of the benefit, yes.

Thanos Moschopoulos: Yeah, okay.

Phillip Deck: There (unintelligible) in that variable in that, too.

Thanos Moschopoulos: Okay, well I'll ask a different question then, you know, aside from the exchange rates and, you know, the rates which you've locked in which you outlined for us, should we expect much in the way of variability as far as the expenses? Is the plan basically to keep headcount relatively flat?

Phillip Deck: Relatively flat, yeah, I think is a logical assumption. We're not planning on any kind of aggressive expansion of the team. And, you know, we're certainly in a cautious mode, even though we see lots of opportunity for licensed growth. You know, obviously we're paying attention to the environment here.

Thanos Moschopoulos: Okay. Now, as far as the services margin, that's strictly a function of utilization. Does currency play a role in that at all?

Phillip Deck: Currency would, right?

Doug Sawatzky: Yeah.

Phillip Deck: In margins? This is in margins.

Doug Sawatzky: No. Can you repeat your question Thanos?

Thanos Moschopoulos: So I guess my question is as far as the services margin, is that mostly, do you bill resources in the same currency as the cost of goods or is it a case where you have maybe Canadian dollar expenses that are being shipped down to service U.S. (dollar) contract?

Doug Sawatzky: It's mainly built in the same currency that the cost is. You know, one of the reasons for the high margin, as Michael mentioned in his comments, the engagements that were going on are longer and longer which allow us to realize a higher utilization of our services (batch) during the quarter.

Thanos Moschopoulos: Okay.

Phillip Deck: Except for in third quarter because it's Christmas typically.

Doug Sawatzky: Right.

Thanos Moschopoulos: Okay. And just further on the competitive front, you commented on IBM Jazz. Any other changes in the landscape?

Borland has been talking for a bit about their BMS, is that having any impact at all in terms of the customer base or are they really targeting in different segment than you guys are focused on?

Phillip Deck: I can only assume they're targeting a completely different customer base than we are because we almost never see Borland.

You know, we continue to see IBM. We see HP once in a while, although we're very successful against HP. You know, we see Serena once in a while, although mainly as they're trying to upgrade from their end of life customers to their other products and we have a pretty good record against them, as well.

But otherwise, not much change.

Thanos Moschopoulos: Okay. And just finally, in terms of how customers are reacting to the recession and the economic climate, is there any significant difference between, you know, North America versus rest of world or is it really much more of a function of what particular vertical industry the customer happens to fall into?

Phillip Deck: Well, I would - you know, I don't think that this quarter is all that representative, but certainly in this quarter our North American business was far stronger than anywhere else.

Now, again, I wouldn't take one quarter to - as a sign of that because we're extremely excited, for instance, with what's going on in Japan and some of our Japanese customers. And so looking forward, we see a ton of opportunity coming out of Japan.

I would say that certainly Europe is in some ways the most sluggish in terms of pipeline growth. You know, lately our North American business has been much more stable than anywhere else in the world.

Thanos Moschopoulos: Okay, great. Thanks. I'll pass the line.

Phillip Deck: Sure.

Operator: And as a reminder, to register a question, you may press the 1 and the 4 on your telephone.

And there are no further questions at this time.

Phillip Deck: Well thank you very much for everyone for participating in the call. We look forward to updating you further in the months ahead.

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

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