

MKS INC

Moderator: Jennifer Lombardi
June 2, 2009
5:00 pm CT

Operator: Welcome to the MKS Fiscal Year 2009 Q4 Year End 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, June 2, 2009.

I would like now to turn the conference over to Philip Deck, Chairman and CEO. Please go ahead, sir.

Philip Deck: Good afternoon and welcome to our Fourth Quarter conference call.

I'm here in Waterloo with Michael Harris, the President and Chief Operating Officer and Doug Sawatzky, our Chief Financial Officer. But first I'll turn to (Larry Walishon), our Legal Counsel for the legal disclaimer.

(Larry Walshibon): 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 future events or conditions or that include words such as expect, anticipate, intent, plan, believes, estimates, or similar expressions, are forward-looking statements within the medium securities laws.

Forward-looking statements include information concerning possible or assumed future results of operation 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 these events. The future results assure the value of MKS, and may differ materially from those expressed in these statements, detailed among others those factors that are in MKS's failings with Canadian securities regulators.

MKS is not undertaking 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. And I'll turn the call back to Phil.

Philip Deck: Thanks, (Larry).

Today MKS reported financial results, including record annual operating profits for our fiscal year ended April 30, 2009. MKS overcame the economic challenges of 2009 to produce our best year ever for customer success, strategic progress, and operating profits.

Even in a year where licensed revenue growth has been hard to find, we've succeeded by focusing on winning new customers that can represent new sources of long-term demand. We worked with our customers to deploy increasingly capable, sophisticated implementations, and we made investments in R&D needed to extend our technology leadership.

In the end, using our unique application life cycle management platform to solve our customers' most challenging problems resulted in a year that advanced our strategic objectives, delivered record operating profits and set us up for robust growth in the years ahead.

For the year ended April 30, 2009 we recorded \$58 million in revenue, a decline from 5% from last year. Our licensed revenue was the largest contributor to the slowdown, which began quite sharply in early November. Adverse currency trends affected our maintenance revenue as well, again primarily in the back half of the year. But good cost control and lower expense on Canadian-denominated expenses allowed us to show strong operating profit, growing 20% to \$4.1 million for the year.

For the fourth quarter, we reported \$13.6 million in overall revenue, including ALM license revenue of \$2.8 million. The license revenue reflected a continuation of the sluggish license total from Q3 of this year, with a similar lack of any license transactions over \$500,000. This was a significant decline from the fourth quarter of 2008, when we recorded an unusually large \$5 million license transactions, but an improvement over the third quarter of this year in both revenue and profit.

Our closing cash balance at April 30, 2009 was \$17 million, a \$4 million increase from the \$13 million balance at April 30, 2008. During the year, we paid \$4 million in dividends, as well as repurchased and cancelled \$2.2

million shares for a total cost of \$3.6 million under the terms of our normal course issuer bid.

We announced today that our board of directors has declared a quarterly cash dividend of 2-1/2 cents per share on our outstanding common shares, a 25% increase over the 2 cent per share dividend in the previous quarter.

In the fourth quarter, our services showed continued strengths as we worked to implement increasingly large-scale implementations of MKS integrity. Our backlog remained stable in spite of the low level of new license activity, and remains at a healthy level of about two-quarters of service deliveries.

In 2009, we won more new product mandates and commitments with major customers around the world than ever before. This was made possible by our steadily improving ability to prove the advantages of MKS integrity to the most demanding and knowledgeable software development organizations in the world.

As it turned out, many of the most promising new customers we won didn't have the capital budgets to buy licenses at the level we would have liked or expected. However, as these customers roll out their initial licenses, we anticipate that these significant sales initiatives will yield solid business growth in the years ahead.

I'll now turn it over to Michael Harris for the operational update.

Michael Harris: Thanks, Phil.

We are pleased to report another profitable quarter for the ALM Division and for MKS as a whole, even with an ALM licensing result which was less

than expected coming into the quarter, not to mention at the start of the fiscal year.

Softer than expected licensing aside, there is much positive news worth sharing at MKS. The last couple of quarters have clearly been a challenging time in which to close software license deals. In spite of these challenges, however, we made some good progress on several important projects in this quarter, which resulted in the overall positive performance.

We have spent a great deal of time this year competing for selection as the ALM supplier to a number of major organizations, existing and new customers alike. These competitions have been far more focused in ALM as opposed to any of the component disciplines than we have seen in the past. In the majority of these cases, we have succeeded in improving the benefits of our ALM platform and have established ourselves as the chosen ALM supplier.

However, having reached the conclusion of many of these selection processes, we generated far less license revenue than even those customers would have expected at the outset, as the severity of the recession worsened. These wins are important, however, as they offer us the opportunity to prove our customers' choice was right and to set us up for much more steady license revenue gains in the future.

Similar to the third quarter, we closed no large license deals this quarter. In fact, our largest license transaction came in at approximately \$300,000. We had a significant proportion of our license sales coming from follow-on wins with our regular customers, such as Deutsche Telecom, Despace, EADS, Honeywell, ICT Electronic Systems and Magna Electronics. As for our recent

press releases, we also closed important deals with All Nippon Airways and TRW Automotive.

Our IO team contributed to the overall results again with revenue of \$1.8 million, down 11% from the same period last year. Even with the decline in revenue and thanks to careful cost management, this group still managed to drive \$400,000 of earnings. The consistent sales and earnings performance of IO continues to be an important part of the overall MKS financial result.

In this environment, we are managing our headcount cautiously but continue to be on the lookout for prospective field team members, both sales and services in particular geographies of verticals, as we want to steadily add to our customer facing organization.

We finished the quarter with 309 total headcounts, a 2% decrease over the January 31 close in the headcount as 314. Our ALM sales count headcount finished unchanged from the end of the third quarter at 32. Without the benefit of any larger transactions, our per-sales rep productivity increased only marginally to 188,000 from 183,000 during the prior quarter.

Our ALM services revenue growth continues at its steady historical pace, with this past quarter showing a 13% increase over a year ago and a 7% increase over the third quarter to \$2.7 million. The increase over the past quarter and year is dominated by several major long-term projects and not just the services associated with the recent licensing transactions.

These larger projects have us going far beyond training the end users and implementing out-of-the box software. Besides these basic implementation services, it also has us working in consulting engagements with our largest customers to ensure that their specific engineering processes are implemented

fully in MKS integrity. Only this way will the full value of MKS integrity be realized and enable follow-on license acquisitions to proceed.

All of this being considered, we continue to depend on the strategic service partners we have on board who can help us to deliver the backlog of services that our customers require.

This past quarter we signed a strategic partnering agreement with BMC, which has a great deal to offer our joint customers and the market as a whole. Most IT departments have divided into IT development where software is developed and maintained, and IT operations, where software is deployed and used. We have a dominant capability in IT development while BMC is a global leader in IT operations.

But there is a critical need to integrate IT development and IT operations processes in order to provide a true enterprise view of the IT organization. In collaboration with BMC, we have created such an integration and our partnership allows BMC to market MKS integrity along with their market-leading business service management products to their customers worldwide.

The combination allows BMC to offer a unified capability for the entire IT department as well as provide a management reporting layer across both groups, providing a complete view of the enterprise IT picture. We are already engaged in a number of accounts and expect to drive some revenue from the partnership in the coming quarter.

For the coming year, we will continue to focus on winning key mandates in the largest most challenging accounts worldwide, based on the growing demand for unified ALM. We are in an excellent position to achieve strong returns from the investments we've made, become even more strategic in

these accounts, and ensure that when spending does loosen up that we are ready to take on projects which are so critical to our customers' success.

Back to you, Phil.

Philip Deck: Thanks, Michael.

We expect to release a major upgrade to our flagship MKS Integrity Platform in August 2009.

With the addition of test management, the last remaining ALM discipline to be fully addressed within our product and the end-to-end vision of MKS integrity is now complete. We now offer unparalleled breadth of capability in every aspect of application life cycle management along with outstanding capabilities for configuration, collaboration and change management throughout.

The test management market is compelling. Most immediately, it gives our existing customers the capability to complete their end-to-end fully automated life cycle implementation. We've worked closely with our major customers on its development, and these customers will likely be the first to implement. But the capability opens up close to \$1 billion market for us as companies recognize the benefits of test management capability that's part of an ALM platform, not just bolted on or integrated post-sale.

For MKS, test management represents an opportunity to complete the ALM vision that our customers are embracing, as well as a major new market in its own right.

We have a very focused strategy to operate safely through this period of constrained license spending while setting the stage for ambitious growth as the economy recovers. In the past few quarters, we've been focused on winning the hard-fought product mandates that establish MKS's integrity as the standard for major engineering and IT customers, even if those accounts do not have the current capacity to purchase in large volumes.

We've been able to fund these investments in our customer base, due to the steady performance we continue to see in maintenance fee revenue, services and our legacy Interoperability business, combined with careful control over costs. Every new product mandate comes with an opportunity for us to prove our technology in immediate although modest sized deployments, significant potential for future deployments and the addition of reference customers that makes selling our technology much easier.

As the economy improves, as it is starting to do with many of our automotive and banking customers, we'll build on implementation success and incumbent status to build license revenue more quickly, harvesting the rewards for the hard work we're doing during this period.

What is clear from close collaboration with our largest customers and prospects is that the need to better manage the increasing complexity of software development is unchanged by their inability to make investments in the size that they would prefer.

But they are quickly realizing that the business case for transformational benefits of unified ALM and that they also see this period as an opportunity to put the standards and processes in place that they can build on as budgets become less constrained.

Again, in 2009, we received top marks for product leadership from the leading IT analyst firms. Virtually all the rankings awarded by analysts within the ALM sector put MKS product and vision as the leading one in the industry.

This quarter we announced that Gartner Group had for a second time placed us in the leadership quadrant in their software configuration management matrix. Gartner estimates that a comp down to annual growth rate of 10% for the SCCM market through 2013 and states that, quote, "Growth will be focused on products that incorporate ALM capabilities," end quote.

In Gartner's view -- again quoting -- "SCCM tools have evolved on a path towards integrating tightly or becoming generalized management platforms for requirements, test plans and other aspects of the application life cycle," end quote.

These independent assertions of MKS thought leadership are continually being affirmed by our customers around the world. The strength of our customer base has shown through in this difficult economy. We have seen no deterioration in the renewal rates from historical levels of maintenance, even in spite of severe budget constraints under which our customers are operating.

Particularly in these times, the need to maintain quality, build software development productivity, and reduce product release cycles, remains of paramount importance to customers, and MKS integrity plays a vital role in the attainment of all these objectives.

Our currency situation would appear to be a bright spot in our outlook for the coming year. Canadian dollar costs should be well contained by our hedging program, and the high year-end pound if current levels persist, may result in better maintenance fee growth. We believe that our strategy to navigate this

period of weaker demand has maintained our financial strength and has positioned us to return to robust license growth in as soon as possible time frame.

We've not offered any specific guidance for the year, simply reiterating our commitment to profitable organic growth in our primary operating segment ALM and an expectation for continued declines in our legacy Interoperability business of about 10%.

We remind our shareholders of the normal seasonality of our cash flow, typically declining somewhat in the first two quarters and then rebuilding in the last two based on the seasonality of maintenance renewals.

We've mitigated the risk to our business model posed by fluctuating currency, we've planted the seeds to significant recovery of license revenue, and we are succeeding in delivering profit growth in spite of the turbulent economy. Our long-term strategy is becoming increasingly validated by our customers and partners, and we're well positioned to thrive in the year ahead.

We appreciate the support and confidence of our shareholders, and we're committed to present increasingly positive results. We believe that we can build on the success of 2009 in the years to come, and look forward to seeing as many shareholders as possible at our annual general and special meeting in Waterloo at 4:00 p.m. on July 7, 2009.

I'd now be happy 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 on your telephone. You'll 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 the speakerphone, please lift the handset before entering your request.

One moment, please, for our first question.

And our first question comes from the line of (Tom Lifton) with (Verson Partners). Please proceed with your question.

(Tom Lifton): All right. Thank you. Good afternoon.

Phil or Michael, can you just comment further on some of the newer wins announced from today. Would these be maybe a dozen type of customers that are probably \$1 million or more in license that are really just at the very start of things?

And the second part of that question is, certainly the first few months of the year budgets were effectively frozen. Are you starting to see a little bit of movement where they're starting to deploy a bit, or where are we in that cycle?

Michael Harris: Yeah. Okay, (Tom). So yes, probably a dozen is the right number.

Most of these accounts were current customers where we've had an installation for two or three years and have been working really hard to go beyond the requirements or beyond FCM and have now received mandate to go across the whole organization.

And the potential in each of these accounts is more than a million; it's several millions of dollars. A couple of those were new additions, but for the most

part it's been accounts that we've always been in that only slightly penetrated. And so it shows you that these sales cycles can be long.

And we expected a lot of these mandates to happen when they did, but obviously we expected revenue to follow soon after, and that's what didn't happen.

As far as the budgets unfreezing, yeah, we're starting to see a glimmer of that. Particularly hard-hit for us was a lot of our automotive customers, particularly in Germany. And the hardest hit are now again starting to buy licenses. They've been continuing to invest in services and have been continuing to deploy, but now they're starting to talk about purchases within this calendar year, and before it was really - we don't know when we're going to be able to get back to start buying licenses again.

So we're starting to see a thaw, but it's not right away. It's this calendar year.

(Tom Lifton): And just with the BMC agreement, how do you manage the sales forces and in terms of tackling opportunities and such?

Michael Harris: It's joint and so region by region they're all run a little bit differently.

But these relationships are all forming at the regional sales director and sales rep level. So there's a couple of opportunities that are very, quite imminent, and those are relationships that started at the rep level in accounts that we were working jointly.

In others, in Scandinavia, for instance, we've found some brand new opportunities together, and the same as the case in Germany. So I would say there's no standard across the board other than this isn't being run by us at

headquarters, saying, thou shalt go and find opportunities with BMC - it's very much deal driven, rep driven and regional sales director driven.

So in almost all of the more exciting opportunities, there are joint accounts, where together we're moving business along a bit faster than we thought and probably increasing the deal value more than we would have probably otherwise had.

Philip Deck: (Tom), I guess I'd add to that that talking about things unfreezing, certainly the economy seems to be unfreezing, particularly in the really big cyclical companies. January and February really was an awful time because they were having to eat all the inventory liquidations and really weren't shipping much. And that's definitely loosened up as they've now started shipping again.

But the bigger sense of unfreezing of the market is that, as you well know for the last six or seven years we've been preaching the vision of unified ALM and the ability to collaborate across different parts of the application life cycle. But we've always had to have a strategy that to some degree compromises on that vision, because most customers have not been looking for ALM; they've been looking for one of the components of ALM, whether it's requirements management or SCM or test management or deployment management or defect management.

And so we've tended to often have to downplay the ALM message in order to go in and win mandates in one of the component areas. And the thing that's most exciting and important and reassuring to us is that we see a significant increase finally in the number of companies that are actually looking at ALM and saying that it's not just standardizing across one of the main disciplines or standardizing within a division, but they see that the important part is to connect the different disciplines of application life cycle management.

And you particularly see that in our new customers, that the newest customers have no interest in one of the disciplines, they're going for the idea of the unification. And that's tremendously important in our business model and our positioning in the industry.

(Tom Lifton): Okay. And just on the (FS) you're hedged, I guess as much as it can be, through July 10; is that correct?

Philip Deck: We actually did one more quarter recently, but...

Michael Harris: Now we've concluded until October 31, 2010 as Phil mentioned, very recently.

Philip Deck: Right.

(Tom Lifton): And just where the dollar is now, do you lay off that a bit, or do you continue to sell until it gets towards prior?

Philip Deck: Well, we did one last week so sadly, we're accepting the reality of the space we're in. We haven't yet actually enjoyed the currency level that is now the stock market for Canadian dollars, so we're just getting down to that and we'll be able to operate around 80 cents for a few quarters. And then we may start picking up if things go and improve again.

But we certainly see continued risk in the higher Canadian dollar, and we have no plans to lay off on the hedging program.

(Tom Lifton): Okay. 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.

And our next question comes from the line of (Stanos Mastropoulos), (BMO Capital Markets). Please proceed with your question.

(Stanos Mastropoulos): Hi, good afternoon. Just drilling a little deeper in terms of the license weakness, is it fair to say that it really was pronounced in the large field size - if we sort of look at the fields in the sort of hundred thousand dollar and below range, were those kind of at the historic run rates, or is there weakness there as well?

Philip Deck: I think we would say there's weakness across the board, certainly that the small and medium size deals have been affected as well. The reason we would tend to focus on the larger deals is that's where the more significant impact and in some ways some more surprising impact happened.

In the small deals, some of them have just gone away. But it's a little bit different with some of the more major initiatives because we're actually spending all the work, we're actually winning the mandates, we're actually doing implementations, we're actually deploying software. But that initial order seems to be coming in at about 10 or 20% of the level that we would have expected it to come in relative to the amount of investment we're actually putting into the account.

So in some ways it's a little more painful than smaller companies just not buying anything because we're actually spending just as much time and energy to win the deals. And we certainly look at it as a good investment. But we can't record the benefit of that investment on our balance sheet right now.

(Stanos Mastropoulos):and it's the whole bit as the implementation's rolled out that the customers will need to buy those licenses maybe a couple of quarters from now?

Philip Deck: Yeah, and I think that what's reassuring is that they - these are almost all extremely competitive mandates that we're operating under. So this is a process that a large company will undertake; they'll talk to six or eight vendors, they'll narrow it down, they'll do a big bake-off, we'll do a lot of negotiation. We'll have to do some piloting probably.

And then they'll award us the status of being selected as their ALM supplier, which may or may not come with immediate license revenue but has typically be coming with a lot less than we would normally expect.

So they're very important competitions for us to win, and once we achieve the incumbency as the ALM supplier, then doing business later on is much, much more straightforward because we're the accepted vendor and product routes can buy under that approval.

(Stanos Mastropoulos): Okay. Regarding your comments on more and more customers adopting the ALM vision, is that predominantly still on the engineering-focused customer side or are some of the large corporate customers say in the financial phase starting to get that as well?

Philip Deck: I think it certainly is more pronounced on the engineering side. Certainly for us, we continue to see the biggest parts of our demand from the engineering side, so it certainly goes along with that.

But that's not to say it's not happening as well in IT - maybe not quite as pronounced.

(Stanos Mastropoulos): Okay.

And can you talk about your decision to increase the dividend in light of the license weakness we saw this quarter. I guess does that basically speak to your comfort in terms of costs, given your currency hedges and then the pipeline in terms of some of the large customers and their expected buying behavior over the coming months?

Philip Deck: Yeah. I think we - as we've said before, our dividend policy is to pay out cash that's surplus to our needs. I think we even today have lost a fair bit of surplus cash. We don't need nearly this much to operate.

We look at the year going forward and even operating at this kind of license number which we think would be at the low end of what we would expect, we have declining cost from currency, we have maintenance revenue growth. And we've to some degree offset some of the risk factors that we would normally have to deal with through the currency hedges. And so we're pretty comfortable that we can more than support the dividend at this level, and we've made a commitment to our shareholders that we'll continue to review the dividends to make sure we give them back cash that we don't need.

But the sustainability of it, of course, is a big issue for us. And we wouldn't increase the dividend if we didn't think it was sustainable in the quarters ahead.

(Stanos Mastropoulos): Great, thanks. I'll pass the line.

Operator: Ladies and gentlemen, as a reminder, to register for a question it is the 1 followed by the 4. One moment, please, for our next question.

And our next question comes from the line of (Scott Penner) with (T.D. Newcrest). Please proceed with your question.

(Scott Penner): Thanks. Phil, just a quick one.

The new version of MKS Integrity, how well marketed and positioned has it been to your existing customer base? When you launch it and it goes (GA) in August, is there going to be fairly immediate impact on the revenue line or is there likely to be a lag?

Philip Deck: There really won't be any impact I think financially at all.

We'll be shipping it a few months after we had originally intended to ship it. It's been in beta for quite a while with our major customers. We've I suppose raised our bar a bit on the kind of quality we want to see in the release and we're making sure that it's absolutely ready to go before it goes out.

But realistically a lot of customers won't upgrade for a while, as they'll test it out and continue to look at it. Amazingly, even now customers are just now upgrading to our 2007 version, which is two years old. And many of them seem to be really delighted with it. We're amazed they didn't upgrade earlier.

So companies will take a while. But what's important about the release is that it shows customers where we're going. For major customers that are considering a purchase they'll likely look at the new release. But it really wouldn't affect their timing. If they weren't ready to implement it, they would implement it on our existing product and upgrade later.

So it's obviously very different from hardware, where what you spend now might be potentially obsoleted. If you buy our product now, then you get the upgrades for free anyway.

So it's important, but most of our customers have had a very close look at it. Many have participated in the beta. Many have actually participated very actively in the development of test management capabilities. So it won't be a surprise to any of our customers.

(Scott Penner): Okay. And lastly, on just your channel strategy in general, aside from BMC there's obviously other markets around ALM. Are you working on other partnerships, (PLM) and other things that are sort of surrounding your market?

Philip Deck: Yeah.

We think there's a few markets where partnership with us would make a ton of sense. I would say that we're really taking the BMC partnership seriously and we're trying to devote a lot of resources to make sure that it's successful. And so that's a big part of our attention to make sure our field understands what it's about, that we can help support the BMC field organization in selling software.

So we're not wanting to kind of move on just because we've signed an agreement with BMC; the important thing is actually making sure that we can get some software moving down the channel.

But at that point, certainly there's lots of other companies that we talked to and will be talking to about how we can offer the same kind of partnership to their customers.

(Scott Penner): Okay. Thank you.

Operator: 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.

Philip Deck: Well, thank you for joining us on the call today and we look forward to reporting on our progress in the months ahead.

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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