The Packeteer Q3 2005 Financial Conference Call
October 20, 2005
2:00pm PST

AGENDA

David Yntema:

Thank you. Our call today will begin with a summary of Packeteer's financial results for the third quarter 2005. Dave Côté, our President and CEO will follow this summary with an overview of our business. At the conclusion of these presentations, there will be a limited opportunity for questions and answers.

By now you should have received a copy of our press release. In the event that you have not, a copy is available on our website at www.packeteer.com. Today's call is being recorded. A replay of this call, along with management's script can be accessed on our website.

FORWARD LOOKING STATEMENT

During the course of this conference call, we will discuss with you some of the factors we currently anticipate may influence our results going forward. These forward-looking statements include express or implied statements regarding future revenues and revenue growth as well as gross margin targets, the markets for our products, customer deployments of our products, our ability to continue to innovate and obtain patent protection, operating expense targets, future profits, liquidity, new product development and delivery dates, and macro economic conditions. These statements represent the views and judgment of certain members of management and are based on limited information available to us now, which is subject to change. We currently expect to provide guidance regarding our results going forward only during each quarterly financial conference call, and we do not plan to otherwise update that guidance. Actual results may differ materially from those stated or implied by the forward-looking statements we may make today. Such statements are subject to risks and uncertainties, including the risks described in the press release announcing this call and the risks discussed in the Risk Factors section of our 10-K filed with the Securities and Exchange Commission on March 16, 2005, and our 10-Q's and other reports filed with the SEC from time to time.

REGULATION G DISCLOSURE

We will be using non-GAAP financial measures in this conference call, which exclude the amortization of purchased intangible assets and deferred stock-based compensation, partially offset by the tax effect of these items. For a detailed reconciliation of these financial measures, please see our website at www.packeteer.com under Company – Investors – Conference Calls. In accordance with SEC guidelines, the presentation of the non-GAAP financial measures is not meant to be considered in isolation or as a substitute for the Company's financial results prepared in accordance with GAAP.

THIRD QUARTER HIGHLIGHTS

STATEMENT OF OPERATIONS

For the third quarter 2005, net revenues were $24.8 million compared with net revenues of $28.2 million for the second quarter 2005, and $23.1 million for the third quarter 2004. For the third quarter 2005, the Americas net revenues were 51% of total net revenues which includes the majority of Mentat's revenues, compared with 41% for the full year 2004, while Europe net revenues were 32% for the third quarter 2005, compared with 32% for the full year 2004, and Asia-Pacific net revenues were 17% of total net revenues, compared with 27% for the full year 2004.

Our top 10 customers accounted for 76% of total net revenues in the third quarter 2005, higher than the 65% reported in the second quarter 2005. Our largest distributor in the U.S., Alternative Technologies, accounted for 26% of total net revenues in the third quarter 2005, compared with 24% in the second quarter 2005. Westcon, who is a distribution partner in North America and Europe, accounted for 12% of total net revenues in the third quarter 2005, compared with 11% in the second quarter 2005. No other customer accounted for more than 10% of total net revenues in the third quarter 2005.

Our reported third quarter 2005 revenues fell substantially short of our expectations. This lower revenue resulted from weakness in all regions, particularly in Asia-Pacific. The Americas revenue decline was partly attributable to delays in federal government procurement. EMEA, while up slightly from the second quarter, again failed to meet expectations. Finally, Asia-Pacific's reported revenues suffered from significant delays by its channel in fulfilling end user customer orders. As a matter of company policy, we defer revenue on channel inventory when it exceeds certain levels at quarter end – 40 days internationally and 30 days in the Americas. As a consequence, we needed to defer revenue on that portion of channel inventory for a total of approximately $3.6 million.

Although we have been disappointed in our reported revenues in both the second and third calendar quarters, we expect to regain our momentum in the fourth quarter. Following the second quarter we expected that our third quarter revenues would be a sequential improvement over the second quarter. While we clearly did not achieve that, for some of the reasons that Dave will discuss in greater detail, at this point we do expect our fourth quarter revenues to be at or about the levels we previously expected for the third quarter. We also expect non-GAAP operating income in the fourth quarter will return to our long-term target range of 16-18%.

Gross margins for the third quarter 2005, excluding the amortization of purchased intangible assets of $401,000, were 75%, the same as the 75% reported for the second quarter 2005.

Research and Development expenses for the third quarter 2005, excluding the amortization of deferred stock-based compensation of $217,000, were $5.3 million, or 21% of total net revenues, compared with $5.2 million, or 19% for the second quarter 2005. The increase in expenses in the second quarter was primarily attributable to increased headcount and product development costs. We expect that our non-GAAP Research and Development expenses will approximate our long-term business model target of 18% going forward.

Sales and Marketing expenses for the third quarter 2005, excluding the amortization of deferred stock-based compensation of $8,000, were $8.9 million, or 36% of total net revenues, compared with $9.3 million, or 33% for the second quarter 2005. The decrease in expenses in the third quarter was attributable to lower personnel related expenses, including bonuses and commissions resulting from lower revenues. We expect that non-GAAP Sales and Marketing expenses will be closer to the higher end of our long-term business model target of 30-32% in the fourth quarter of 2005. General and Administrative expenses for the third quarter 2005, excluding the amortization of deferred stock-based compensation of $2,000, were $1.8 million, or 7% of total net revenues, compared with $1.3 million, or 5% for the second quarter 2005, meeting our long-term target of 6-7%. The sequential increase experienced this quarter was largely a result of additional professional fees associated with audit and tax related work.

Operating income for the third quarter 2005, excluding the amortization of purchased intangible assets of $401,000 and the amortization of deferred stock-based compensation of $227,000, was $2.6 million, or 11% of total net revenues, compared with $5.3 million, or 19% of total net revenues in the second quarter, substantially below our long-term target of 16-18%. Our plan for non-GAAP operating income in the fourth quarter assumes a return to our target range of 16-18%. Other Income (net) for the third quarter 2005 was $776,000 compared with $609,000 in the second quarter 2005. The increase was primarily due to higher yields on our investments.

Our tax provision in the third quarter 2005 was 19%, consistent with last quarter's estimate of our annualized tax rate. This outlook does not include any one-time impacts that may result from the repatriation of permanently reinvested off-shore earnings under the American Jobs Creation Act, or the possible additional release of our existing valuation allowance. For planning purposes for 2006, we estimate the reported provision to increase to approximately 20-25% on an annual basis.

Non-GAAP net income, which excludes the amortization of purchased intangible assets and the amortization of deferred stock-based compensation, offset by the tax effect of such items, was $2.8 million or $0.08 per diluted share.

Total headcount was 312 at September 30, 2005, up from 301 at June 30, 2005, with the increases in customer support, research and development, and sales. Our plans call for modest headcount increases in the fourth quarter, targeted mainly in the sales organization.

BALANCE SHEET

Total cash, comprised of cash, cash equivalents, and investments, was $113.0 million at September 30, 2005, an increase of approximately $5.4 million from the balance of $107.6 million at June 30, 2005. Trade receivables of $17.2 million at September 30, 2005 resulted in approximately 64 days sales outstanding, compared with 61 days reported for the June quarter. The increase in DSO was primarily the result of an increase in deferred revenue related to channel inventory reserves in the month of September. Excluding this deferral of revenue, our DSO would have been 56 days.

Our reported inventories, which are primarily comprised of finished goods, were $6.4 million at September 30, 2005, compared with $5.7 million at June 30, 2005. The increase in inventory was attributable to the shortfall in sales and the purchase of component parts from one of our contract manufacturers, as we are once again concentrating most of our current manufacturing with a single contract manufacturer. We would expect these levels to decline in the fourth quarter, and continue to decline early next year.

Our deferred revenue balance at September 30, 2005 was $25.2 million, compared with $22.0 million at June 30, 2005. The majority of the deferred revenue balance continues to reflect our maintenance billings that are amortized over the lives of the individual contracts, which are generally between 12 months and 36 months. Most of this quarter's increase is attributable to our revenue recognition policy with respect to channel inventory.

I'll now turn the call over to our CEO, Dave Côté, for some specific comments on the state of our business. Dave.

Dave Côté:

Thanks David, and thank you everyone for joining us today. Our third quarter of 2005 was extremely disappointing and well below our expectations, across revenue, operating income and geography. The Americas represented 51% of our revenue. EMEA delivered 32% of Q3 revenue. Asia, which was significantly affected by the deferral of revenue associated with excess channel inventory, came in at only 17% of revenue after the deferral.

Even with our major disappointment for the quarter, large opportunities continue to be the primary focus of our sales efforts. In the third quarter, there were 37 deals over $100K, just ahead of the number of deals greater than $100K in Q2 2005. The average deal size was up to about $215,000. In

Q3, product revenue contribution included 65% of product revenue from core units with the balance from edge units and other. The unit split remained approximately 60/40 - edge to core units. PacketShapers with Xpress delivered a contribution at approximately 20% of product revenue and shipped on 30% of all units. Due to the serious shortfall in revenue, our service business accounted for 29% of total revenue.

Turning to the specifics of our third quarter performance, I will break down the elements of our underperformance by territory.

Our EMEA operation missed our expectations. While several of the deals delayed in Q2 were closed in Q3, the overall revenue rate was a disappointment. We continue to believe that this shortfall is neither related to market conditions nor increases in competitive activity. We believe that it is primarily related to our own poor execution as a company in EMEA. In the past several months we have strengthened our team in the Dach region (Germany, Austria and Switzerland), and we are adding resources to our efforts in the Middle East and Africa, which is the fastest-growing region in EMEA. Arturo Cazares, our vice president of worldwide sales will spend a good portion of his time in our fourth quarter working with the EMEA team to improve their business. He will be conducting detailed territory reviews to assist in driving performance.

The Americas also missed our expectations, though the bulk of that miss can be attributed to deals that slipped into Q4, including in particular sales to the federal government. The timing of larger deals continues to be a challenge for us. As larger deals become an increasing portion of our revenues, slippage of a small number of deals can have a material impact on our revenues. We are focusing our sales team and executive management on more tightly managing our deal pipeline to drive closure of these large deals in a more timely way.

Finally, our APAC region created the majority of our shortfall due to channel inventory issues. During the quarter, two of our larger distributors began seeding programs to open new markets in Southeast Asia and China. Those units, many of which are placed at resellers or customers, remain in their inventory until they are sold through. Additionally, as the quarter was back-end loaded, several partners throughout Asia simply were unable to sell-through their inventory at the end of the quarter. As a result of these two factors, our APAC channel partners had substantially higher inventory at the end of the quarter and we needed to defer revenue on the portion of that inventory in excess of the company's revenue policy which resulted in the lower sales. As a matter of company policy, we defer revenue on channel inventory when it exceeds certain levels – 40 days internationally and 30 days in the Americas. After detailed discussion with many of our partners over the last two weeks, we believe that the inventory issues do not imply an overall slowdown in the business, and, in fact, reflect a broadening of our opportunity in those targeted markets. Nonetheless, we have put resources in place to work directly with all of our international partners to provide greater visibility into their inventory levels on a more granular basis.

While we believe that the bulk of the miss was related to the issues I outlined above, we are also concerned that our planned integration of the Mentat-acquired acceleration technology has slipped by several months. While this did not affect revenue directly in the third quarter, it is certainly of concern. We have opportunities to provide incremental small features to our products to meet the needs of large customers, thus enhancing revenue. Examples of this include specific application classifications for large customers, or the addition of adaptive response agents for specific customer environments. To meet this need we are adding several resources to our sustaining engineering team.

On a related note, after discussions with Mike Schumacher, our vice president of engineering, we have decided to part ways. We would like to thank Mike for his efforts during his time at Packeteer. In the interim, as we search for a new head of engineering, Manny Freitas, our vice president of Operations, will have sustaining engineering report to him. Because Manny, as head of the customer support organization, is very close to our customers and understands their needs, we think that he will be particularly strong in helping us deliver revenue-enhancing features in a more timely way.

Fundamentally, we believe that our market continues to represent a growing opportunity for Packeteer. While there has been an increase in competitive activity, we do not believe that competitors are the major factor in our results. As a company, we must improve our execution of both product development and our selling strategy. And that is our commitment to our customers, partners, employees and shareholders. We will focus much more intently on pipeline management and closing large opportunities more quickly. To that end, we are in the process of completing detailed territory reviews in both EMEA and the Americas, which are designed to insure we are addressing the priority issues and opportunities for each of our sales territories. We will also put specific resources in place to help our partners and sales management to jointly manage channel inventory primarily in our international geographies. We will tighten our processes and execution on product development, both new products as well as features in our existing releases. In the end, we believe in the ongoing success of our company, but understand that success will only be recognized through the ongoing demonstration of improving results…and that demonstration is our goal.

In other news, I'm pleased to report that in September, we announced a sales and marketing alliance with Tacit Networks to deliver a "Best-of-Breed" server consolidation solution. This alliance will enable joint customers to consolidate and centralize email, web and file servers at corporate data centers while delivering optimal application performance to branch-office users. Tacit sells a fully complementary file system appliance that accelerates the branch office user experience. When combined with Packeteer's industry-leading solution for optimizing application performance over the WAN, customers will be able to implement the broadest and most effective solution for server consolidation and WAN performance. Packeteer and Tacit will be engaging in cooperative customer support, joint development and sales and marketing activities. We're excited about this alliance and its role in our server consolidation marketing initiatives overall. We think it continues to speak to the importance of our technology and we continue to look for other similar partnering opportunities.

Once again, thank you for your time. Now I'm going to turn the call back to David Yntema for Q&A…

David Yntema:

Thanks David, and thank you everyone for joining us today.

INTRODUCTION OF Q&A (David) This concludes Packeteer's financial and business presentations, and the call will now be open for Q&A. Our moderator will now review the Q&A process.

(Operator) **CONCLUSION OF CONFERENCE CALL** This concludes the Packeteer Third Quarter Financial Conference call. Thank you for joining us today. If you have additional questions, please feel free to call our Investor Relations line at 408-873-4422.