
MANAGEMENT DISCUSSION SECTION

Kevin Liu, Analyst, B. Riley & Company

We'll go ahead and get started with our next presentation today. Up next we have Actuate. Actuate, as many of you probably know, provides reporting and performance management applications to the enterprise. Presenting for the company will be Pete Cittadini and Dan Gaudreau. Sir, go ahead.

Peter I. Cittadini, Chief Executive Officer and President

Thank you, Kevin and welcome everyone. We'll get through this crisply, Kevin, just a quick question on the format, 30 minutes Q&A at the end. Okay, we'll get it through it efficiently so we can get to the Q&A.

So let's start, a little bit about Actuate Corporation. We're Silicon Valley based, however a very substantial global footprint, primarily because of the customers that we sell and service, primarily global financial services institutions and very large OEMs.

So you see the footprint on a global basis, quite international, about 4,500 customers plus on the list today, again, mostly financial services, defined as banking, brokerage and insurance, but quite a horizontal business for us beyond that, full-services shop and some key global partners that we go to market with.

What Actuate does and the power that you get with Actuate is behind this schematic. We bring together a new development – application development environment called BIRT that is open-source oriented, which means it's freely downloadable by developers who are interested to work with it.

Our company, which also includes integrated commercial offerings that sit underneath BIRT-based applications allowing for scale, performance, reliability and security aspects to that BIRT-based application and a community of 750,000 plus developers, ever growing community that make application development faster and easier because of the size of the community.

Typically, what people do, half way up the chart is either build Internet inside the firewall applications for their firms, so their employees become more efficient in running the business. Examples would be performance management, reporting business intelligence types of applications or extranet outside the firewall types of applications that are typically customer-facing applications that are there for satisfaction, loyalty, ultimately more revenue from your customer base. And above those 2, sort of genres of applications you'll see various specific types of applications that our clients are building with BIRT and Actuate.

Today, we continue to do business with the Who's Who of financial services companies. You'll see the logos up here and they're instrumental to our core, and this is a representation of our core business today, not even including a lot of the new BIRT business and customers. If you will, I'll show you some of those in just a little bit. But again, open source, it was not only about the new product, BIRT, it was a new business model at Actuate that was going to be relevant to the market and shareholders of the company. And it has 3 phases associated with it. One, global market expansion and ubiquity of this product called BIRT used everywhere, and today, as I said we have 750,000 plus developers.

Phase II that we're currently focused on is the revenue acceleration phase, leveraging these developers to do more of those extranet and intranet applications that we talked about previously.

And the life-to-date BIRT Business alone associated with the new product line is 45 million plus life-to-date and 450 plus customers associated with that new product line.

Ultimately the revenue acceleration is there to drive lower cost of sales and marketing. Because of the ubiquity, people come to Actuate in a warmer state, not as cold and thus we're able to more efficiently transact business with them and drive operating margins up. The long-term schematic is to -- roughly at twice our size, approximately 250 million, to be able to give shareholders a 30 to 40% operating margin.

So we believe that tying together enterprise software with open source software techniques, you create a new business model that will become relevant and attractive to public companies' shareholders.

When we look at the BIRT Business specifically in Q1, it was up from a license standpoint, 30% year-over-year, and again, in the software business, licenses are sort of the key metric. When you look at some of the investments that we've made and you look at registrations associated with an investment like BIRT Exchange, it's a new website associated with supporting BIRT developers.

Today we have over -- or close to 28,000 BIRT registrants on the site and when you look at Q1 statistics from an average daily page views, monthly visitors, unique commercial downloads, you'll see that Q1 year-over-year increases are all up and to the right. We also created a marketplace as part of birt-exchange.com where you can look at the types of applications and freely download the types -- different types of applications that BIRT is uniquely able to create for you as a solution. So for those of you that are website savvy, we do encourage you to come to birt-exchange.com and look at the at the BIRT Exchange marketplace.

Again, a couple of the other salient metrics. The overall business, this is above and beyond just the license business, was 3.8 million, up from 3.5 a year ago. As we said, the license business was up 30% year-over-year and within the confines of the quarter we did in excess of 135 transactions associated with that new open-source product line.

Another investment that we recently made within the confines of Q1 that already paid dividends to us within the confines of Q1 is BIRT onDemand. And what this is, is a platform offering, so if you don't have a computer available to you or that -- or if you can't afford the commercial products available for on-premise, running BIRT reports today, we allow you an easy way to log into a cloud environment, a hosted environment from Actuate called BIRT onDemand and try out either our applications or your custom-built applications on a full blown commercial Actuate and BIRT server environment.

And again, this just launched in beta form February 22, and within the confines of the remainder of the quarter through March 31, we got these logos that have signed up, registered and are using BIRT onDemand to again experience the possibilities with Actuate Corporation. All extremely, extremely good signs.

The other thing that we are doing with BIRT is pre-training through a host of roadshows on a global basis, and they are extremely, extremely well attended. We had almost 1,000 people attend in '09. 12 roadshows scheduled for the quarter that we are in right now and you see the statistics for quarter 1 with 364 attendees showing up. And again, some of the logos at the bottom are not only people that came to us through this roadshow series, but we've already done commercial business with, starting with a freeware open-source download.

During Q1, February 2, we also did an acquisition of a Toronto-based company called Xenos. And what they do is they primarily take print streams that are typically [inaudible] pages that go to a high-speed printer and they typically take the print stream, transform it into electronic PDF.

We did the acquisition because we see that there is a lot of data within print streams today. That is an untapped market for a company like Actuate Corporation. A lot of people don't cater to print streams any longer, even though they are voluminous and chockfull of extremely mission-critical information.

So what we intend on doing is accepting the print stream and creating BIRT output of that print stream, so you get your first phase of our customer-facing application that's not just static PDF but interactive BIRT pages. That's something that is underway and will be out the second half of 2010, and we believe based on interviews with our customer base, something that will be taken up – actually will be taken up on this offering very, very substantially. And also part of the Xenos product plan within their own product architecture was to come out with Xenos Access, and what that allows you to do is to transform into universally accessible PDF. So if you're visually impaired it immediately is readable by a JAWS reader or what have you, and again, you see that we have great backing by the right institutions that are there in support of the visually impaired. So again, everything created through Xenos that is PDF is universally accessible. So again, no fire drill, spending of substantial money doing one-offs for particular clients of yours or employees of yours that are visually impaired.

And just wrapping up, what you should expect from Actuate in 2010 is double-digit percentage growth in our license revenues, double-digit percentage growth of BIRT-related business within the confines of 2010, continued maintenance revenue growth, continued positive cash flow from operations, and finally, continued best-in-class non-GAAP operating margins, which we define as 16 to 21% operating margins.

With that, I'll hand it over to our CFO, Dan Gaudreau.

Daniel A. Gaudreau, Senior Vice President, Operations and Chief Financial Officer

Thanks, Pete. Before I start I just wanted to repeat what Pete said. We did the acquisition of Xenos on February 2, we concluded it, and so these financial results for Q1 include their consolidated results from that day forward.

So total revenues for the quarter \$30.1 million, up 3% year-over-year. License revenues at 9.6 million, up 10%, maintenance and support revenues at 19 million, up 4%. There are 4 components within that maintenance and support revenue line, which I'll describe in more detail, and those 4 components fluctuate from period-to-period, and then in a couple of slides I'll go into more detail. Our services revenues continue to decline at negative 30% year-over-year. However, that decline had no impact essentially on our operating income.

Operating expenses increased \$1.2 million, up 5% year-over-year. We spent approximately \$2.5 million on compliance-related legal expenses in Q1. The majority of that number is related to litigation we have with Oracle Corporation. And that is -- the matter is scheduled for trial either late June, possibly early July and so you should expect litigation expenses or legal expenses to continue at a pretty high clip in Q2 and taper off in the second half. Operating income, \$4.8 million for an operating margin of 15.9%, and fully diluted earnings per share at \$0.06 in Q1 that's net of a \$0.04 impact – negative \$0.04 impact from the high legal expenses.

Now this chart shows revenues between North America and International. Total revs in North America 23.1 million, up 2%. The revenues internationally grew stronger at 6% or 7 million. License revenues, 7.2 million in North America, up 3% and up 33% in the international markets. Maintenance and support revenues, 14.8 million in North America, up 4% and 4.2 million, up 5% internationally. Professional services revenues in North America 1.1 million and 400,000 internationally, both down year-over-year, but again, de-minimis impact on operating income.

This is the chart I was alluding to before, the 4 components of maintenance revenue. The first and foremost, the largest component is the base maintenance renewal. These are contracts that are due within a quarter and closed within the quarter.

Secondly, first year maintenance that relates to the trailing 12 months of license transactions. Third, back maintenance for transactions that we close this quarter but were due in prior quarters, there is a catch-up component of maintenance revenue that we would book in the current quarter.

And finally, compliance and litigation. That's from -- back maintenance that we -- once we conclude on a compliance or a litigation matter we have to record back maintenance to the point of the infraction.

As you can imagine, it's very difficult to predict the size and timing of maintenance revenues, especially with the back maintenance and compliance categories. However, what I will point out is that the base maintenance renewal, which again is the majority of the line, grew mid-single digit year-over-year and it shows the strength of our maintenance renewal.

Again, Q1 included -- do not include January for Xenos, just the last 2 months. We did orders over 100,000 with 52 customers. That's down from a year ago. It was 62 a year ago, but at a higher ASP of 4%. We did 2 license transactions over \$1 million and that was the same as we did last year.

Non-GAAP operating margin of 15.9%, still a very significant number. However, that was negatively impacted by 8 percentage points because of the high litigation expenses. And we also incurred a negative \$0.01 EPS from FX on the balance sheet translation.

Cash and investments, ended the quarter at \$68.2 million, down 7.3 million. We bought Xenos for \$27 million net of their cash in Q1. That was one of the big uses of cash. Secondly, we continued a stock buyback program in Q1 and we spent \$5 million on that.

Offsetting cash generations were increased borrowings of \$10 million, as well as \$11-plus-million of cash flow from operations, and you can see in the accounts receivable line that's where the bulk of the cash flow from operations was generated. We had a strong cash collections quarter.

The increase in goodwill and purchase intangibles of 27 million was directly related to the Xenos acquisition. And deferred revenue, 45.4 million, although, down 900,000 from year-end, it was up 7% year-over-year.

DSOs ended the quarter at 59 days, down 39 days from December 31 '09 and down 16 days from a year ago. Again, strong cash flow quarter at \$11.4 million primarily from the strong cash collections. We repurchased \$5 million of shares during Q1 and the board has authorized another repurchase for Q2 that we're in the midst of -- in an amount not to exceed \$5 million. We ended the quarter at 572 employees. That was up 75 from year-end '09 and that included the 86 employees that we added as part of the Xenos acquisition.

As Pete pointed out, we do expect to see double-digit percentage growth in license revenue and BIRT-related business. Maintenance revenues will continue to grow, although at fluctuating rates because of the back maintenance and compliance maintenance catch-up items that I described earlier. Q1 cash flow started off very strong and we expect that the full year will continue to be positive. And we believe we will continue with best-in-class operating margins, as Pete mentioned, in 16 to 21% range, despite the high litigation expenses.

And this is a view of our long-term financial model. Our Open Source strategy as well as growth from strategic acquisitions, we believe will allow us to grow our margins significantly. Although we're best-in-class today, we believe that at double our size we'll be able to grow margins by 50%, up to 30 to 35, possibly even 40% through productivity in our sales and marketing as well as scale

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from -- efficiencies from higher scale. So we do expect to see significant improvement in operating margins over time.

That concludes the formal remarks. We will open up for Q&A now. Kevin?

QUESTION AND ANSWER SECTION

<Q>: [Question inaudible]

<A – Peter Cittadini>: Are there more M&A opportunities? Absolutely. We finally have invested in a full-time biz dev person who's looking at the landscape all the time. I will tell you I don't believe that there is anything imminent at this point in time, but there is sort of a corral of companies in areas that are potentially attractive to us.

If anyone interested in us, well, I guess we're on sale on the NASDAQ everyday, and thus we understand the reality of potential forks in the road. But for us as a management team, we believe we have to execute the same way every day, which is become sort of world class and very innovative, highly differentiated.

So regardless of what fork in the road, we decide to set the pace. As an independent we're of high value to shareholders with this sort of hybrid business model strategy, or we get the best premium possible because of our strong, innovative, highly differentiated approach through potential acquisition with somebody else. So, yeah, we're realistic about all of the possibilities ahead.

Yes.

<Q>: [Question inaudible]

<A – Peter Cittadini>: Add-on technology that enable a BIRT, an application written in BIRT, to be fast, handle lots of users, lots of content, things of that nature. So, view BIRT as the development environment which is typically running on a developer's desktop. And then the BIRT iServer, the Actuate iServer is sort of the server-based technology with which whatever you build with BIRT gets the characteristics of scale, performance, reliability and security, and that's how we make our money. The idea is more developers, more projects; more projects, more servers and thus accelerated revenue and profits for Actuate.

<Q>: [Question inaudible]

<A – Peter Cittadini>: No, because it's the same server, so the same server that you purchased from us in -- when the hell did we come out with the first server -- at the tail end of '96 or early '97. It is basically the same building block, but the application is written in BIRT versus a more highly proprietary development environment that we had in our first decade and a half of existence.

So, again, and that's important, because, again, the open source angle is ubiquity across a very large market share of developers that are important to you, so they ultimately do projects and a subset of those projects will require enterprise, scale, performance, reliability, etcetera.

Yes?

<Q>: [Question inaudible]

<A – Peter Cittadini>: Absolutely, absolutely. Yeah. The normal open source model is, try to get ubiquity, product is always free, try to do subscription maintenance associated with the usage of that product. A great model to get lots of people awareness, brand out there, we haven't seen the pure open source model in and of itself besides Red Hat and a few others that got acquired. And I almost feel that we're built for acquisition -- hasn't worked that well in and of itself. We really do believe that we have something innovative and highly differentiated with a combination of enterprise software model coupled with the open source model.

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<Q>: [Question inaudible]

<A – Peter Cittadini>: They are pure open source, that's right.

<Q>: [Question inaudible]

<A – Peter Cittadini>: Combination of -- yes.

Yes, Kevin.

<Q – Kevin Liu>: [Question inaudible]

<A – Peter Cittadini>: Well, the relationships with whoever you are litigating, obviously, is in a turbulent place during the process. I will tell you that we've done many of these that have not transpired in court cases, or having gone through the process, as far as the Oracle process has gone. And in virtually every instance we've gotten at very higher levels than we've ever gotten to at those firms before, and there's a sort of a new experienced, healthy mutual respect as business partners, after the process, believe it or not. But obviously, if you are going to go all the way to court as we intend to with Oracle, it's a bit turbulent during the process.

<Q>: [Question inaudible]

<A – Peter Cittadini>: As substantial, if not more so, because of the doors that we've been exposed to during the process. I know it's not intuitive, but there's actually many articles written on compliance and how compliance can indeed fortify the relationship between two business parties.

<A – Daniel Gaudreau>: And actually there was a significant study done by KPMG, I think, it was a couple of years ago or something like that, specifically related to compliance and how the relationships actually improved.

<A – Peter Cittadini>: Yes.

<Q>: What's the dollar amount involved?

<A – Peter Cittadini>: In which legal case?

<Q>: With Oracle?

<A – Peter Cittadini>: With Oracle we can't get specific since we're sort of mid process, where it's prime time. So we don't want to say anything that would put ourselves or shareholders in jeopardy, but I will just leave it at that.

<Q>: [Question inaudible]

<A – Peter Cittadini>: Misuse of licensing. Pretty much unpaid usage of license that they did not pay us for – for the contract.

<Q>: [Question inaudible]

<A – Peter Cittadini>: It actually related back to the Siebel CRM product suite, yes, that's the big part of their revenue stream today, as you know.

Peter I. Cittadini, Chief Executive Officer and President

Anything else? Everyone ready for sunshine and boxing? No. We are here if you have more questions. Shoot away.

Okay. Thank you.

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