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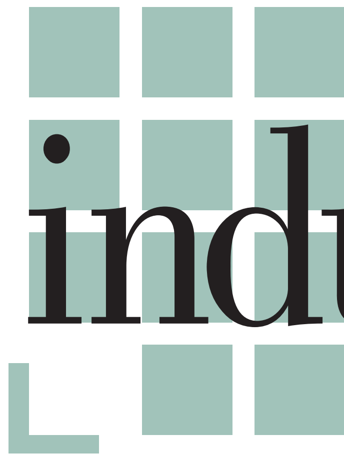


industry update

Vol 18 Issue 4 APRIL 2006

IT for MANUFACTURING, ENGINEERING, CONSTRUCTION AND PLANT OPERATIONS

L O N G A N D W I N D I N G R O A D

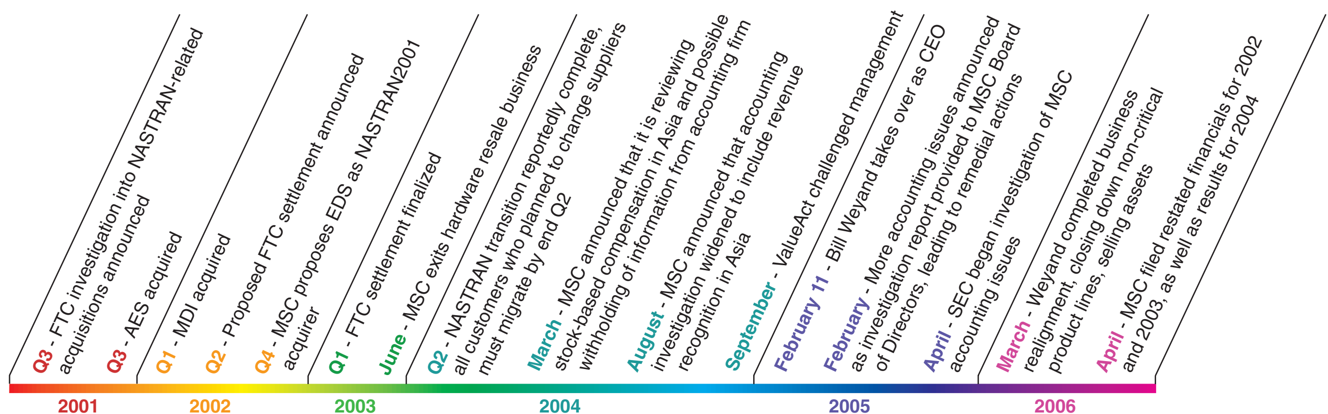
MSC.Software Rewrites History

Net Result of Restatement: Management Free to Focus on Future

By Daratech Research Staff

MSC.Software has had a tough go of it over the last couple of years but is now poised to move forward with an outward focus—on its products and customers. The company's woes started in 2001 with the FTC "matter," then absorbing and divesting parts of two major acquisitions, the effects of the economic changes in the wake of the events of 2001, accounting investigations, challenges to management by investors, a completely new management team—but it all may be nearing an end. A few weeks ago, MSC.Software made the penultimate significant step to putting this all behind it by filing formal reports for 2002, 2003 and 2004 with the U.S. Securities and Exchange Commission. The final step, filing for 2005, should occur in the next few weeks.

MSC Timeline 2001 - present



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The bottom line: Even with all of the challenges, MSC was able to grow revenue every year except one since 1999. Looking only at the revised figures from 2002 through 2004, MSC grew top-line revenue by an average of 9% per year, largely because of growth in maintenance and services revenue, helped by a favorable exchange rate. According to the filings, MSC revenue grew 4% in 2004 and was essentially flat in 2003 when compared to 2002 if one excludes the exchange rate impact.

During this same period, MSC generated cash from operations of $22.7 million, $24.7 million and $33.9 million in 2002, 2003 and 2004, respectively, leading to a cash and equivalents balance of $39.9 million at the end of 2004. Clearly, many customers believed that the external and self-imposed challenges faced by MSC were irrelevant to its ability to provide the products and services the customers saw as integral to their product development processes.

VSOE for Non-CPAs

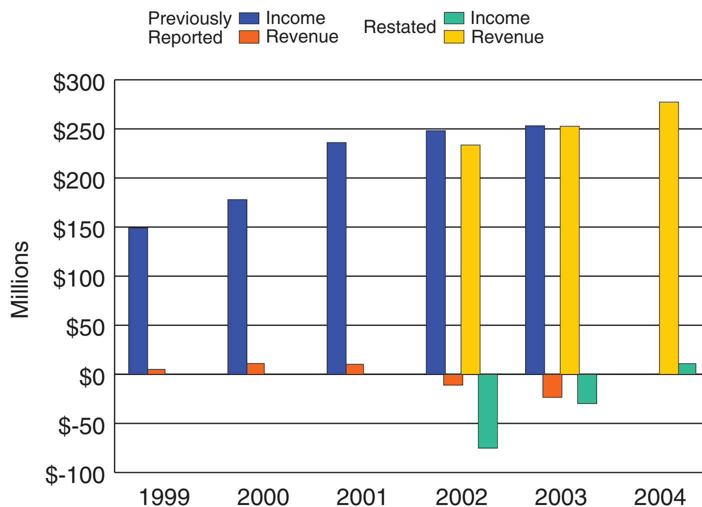
The crux of the accounting problem for MSC is that the company did not have strong rules for accounting for its complex transactions and where it did have rules they were not consistently adhered to around the world. These rules are immensely complex and many software companies have run afoul in interpreting them; while no one at Daratech is a CPA (certified public accountant), following is our understanding of the rules.

Every sale must be accounted for on a company's books when there is persuasive evidence of an arrangement, the fee is fixed or determinable, collection is reasonably assured and delivery of the product has occurred. This "definition" is so vague as to be useless, and many CPAs spend nights and weekends working out their company's Vendor-Specific Objective Evidence (VSOE), basing it on various accounting board pronouncements (SOP-97 and EITF 00-21) designed to "clarify" the matter. What appears to have tripped up MSC is that their contracts often have many elements. When is maintenance delivered: at the time of sale or in chunks, as the year for which maintenance was paid progresses? How should MasterKey deals (under which MSC provides a number of "tokens" for use as the customer desires) be recognized? At the time the deal closes (easy accounting) or as the tokens are used (hard accounting) or on some fractional basis (probably not accurate, medium-hard accounting)? This description is over-simplified, but these are the policies that MSC had to clear up in its revamp of its accounting governance policies.

In the end, MSC decided that its accounting policies in five areas needed to be redefined, leading to the revenue restatements filed with the SEC in April 2006. Each revenue category carries with it associated costs, which we won't go into here; suffice it to say that costs must be accounted in the same period as the revenue, which leads to the changes MSC reported to the SEC on its cost items. From a revenue perspective, the main changes are as follows:

- *VSOE:* The company found that revenue recognition did not meet its standards for a number of transactions. When properly applied, the net effect was to decrease software revenue by $6.8 million in 2002, and increase software revenue by $2.5 million in 2003 from previously reported levels.
- *MasterKey:* MSC changed its policy to recognize this revenue ratably, like software leases and maintenance contracts. This leads to

Restated vs. Previously Reported Revenue and Net Income



a net decrease in services revenue of $2.5 million in 2002 and $1.6 million in 2003.

- *Training and Services:* MSC found that it had, in some instances, recognized this revenue when the customer was invoiced rather than when training and services were delivered. The net effect here was to decrease services revenue by $0.1 million in 2002 and $0.2 in 2003.
- *FTC-related NASTRAN revenue (1):* As part of the FTC settlement, MSC agreed to defer some NASTRAN-related revenue in case a customer requested a refund of license and maintenance fees should they decide to switch providers, as they were entitled to under the agreement. MSC neglected to do this for 5 contracts. The net effect of this was to decrease software revenue by $0.5 million in 2002 and increase software revenue by $0.1 million in 2003.
- *FTC-related NASTRAN revenue (2)*: The company changed the way it accounted for the way the FTC-mandated refunds were handled, both the amount set aside in case refunds were requested and then the actual amount refunded. This change increased software revenue by $4.9 million in 2002 and decreased software revenue by $0.8 million in 2003.
- *Post-contract support:* MSC used to allocate some post-contract support revenue to the software line and some to services on the income statement, as it estimated the software enhancement and upgrades part of the engagement vs. true services components. MSC now believes it is better to allocate the entire sum to maintenance. This has the largest effect on the restatements, reducing software revenue by $25.1 million in 2002 and $25.8 million in the first nine months of 2003 and to decrease services revenue by $48.1 million in 2002 and $40.8 million in the first nine months of 2003.

Note that in all cases, the revenue didn't "go away"—it's being recognized ratably, or every quarter, as the contracts elapse.

To sum it all up, revenue from continuing operations decreased $14.5 million in 2002 and $220,000 in the first nine months of 2003. Including the cost impact of the revenue recognition changes, MSC now reports a net loss of $75.2 million in 2002 and net loss of $29.8 million in 2003.

All of these accounting rules were used to determine the financial results for 2004 (since no filings were ever made, they are not considered restatements). In 2004, MSC reported revenue of $277.3 million and net income of $10.9 million.

Now that we know …

Now that consistent financials have been filed for 2002 through 2004, what can we discern?

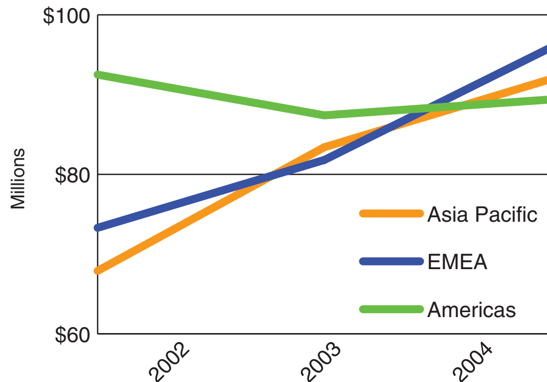
On a line-item basis, software license revenue has remained essentially flat, even as maintenance and services revenue grew by almost 43% over the three years. This dynamic likely has two causes:

- The transition from paid-up software contracts to leases and MasterKey agreements means that there is less revenue recognized in the initial period of the contract in the software line, and more recognized over time in the services line.
- Both software and maintenance revenue were depressed during the period the FTC was investigating MSC's Nastran business. Buyers likely delayed new license purchases and perhaps let maintenance lapse while Nastran's future was unclear. As the FTC matter was settled, buyers began to buy and renew maintenance contracts. MSC doesn't break out revenue by product, but we believe that MSC.Nastran-related revenue still makes up the greater proportion of total revenue.

MSC's strength has long been in the aerospace vertical, especially in North America. The filing included a revenue breakdown by geography and by business line (software or maintenance and services). Immediately obvious is the fact that MSC's presence in the North American market is declining even as it ramps up in Europe and Asia. Software revenue declined 39% from 2002 to 2004 in North America while services and maintenance grew 25%—some of this shift is attributable to the move towards software leases and the MasterKey scheme, but it is nonetheless a worrisome trend. U.S.-based maintenance revenue was always strong (even under the old accounting scheme) since this is where the bulk of MSC's legacy customers are. The total rev-

enue decline in North America over the period was 3%, or an annual rate of –1.7%.

In Europe, the Middle East and Africa (EMEA), software revenue grew 9% and maintenance grew 60%, both helped by positive currency effects. In U.S. Dollars, total revenue grew 31% from 2002 to 2004—probably several percentage points less in constant currencies. On an annual basis, revenue grew 14% in U.S. Dollars.



Asia Pacific was the growth star from 2002 through 2004, with software revenue up 23% and maintenance and services up 51%. On an annual basis, revenue grew 16% in U.S. Dollars.

MSC needs to return to growth in North America—now that the largely U.S.-based turmoil of FTC and accounting issues is almost behind it, the company should be able to focus on growing its presence here.

What's next?

Bill Weyand, MSC's CEO, has said that 2005 was a significant transition year for the company. This is certainly true: since October 2004, the company has hired a new CEO, COO, CFO and general counsel. Other MSC veterans have moved on. The new team has refocused MSC on a core set of products more in keeping with its current strategy of being an enterprise software partner for the biggest and most complex manufactured product manufacturer.

The company opened 2006 with the introduction of MD Nastran, a fully integrated multi-disciplinary (the "MD" in the name) simulation tool that combines the MSC.Nastran, Marc, Dytran and LS-Dyna into one fully integrated solution for the enterprise. MD Nastran allows customers to transition from single point simulation tools to an integrated solution in a single environment, for a more comprehensive simulation. MSC believes that MD Nastran makes the leap from simulating how a design will perform to how the final product will perform. We believe MD Nastran has the potential to greatly enhance inter-disciplinary innovation and accelerate time-to-market—not a bad way to put the troubles of the past in the past.

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