

426

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SCOX - SCO to Comment and Provide Q&A on the Oct. 16th Investment Announcement

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CORPORATE PARTICIPANTS

Blake Stowell

SCO Group - Contact

Darl McBride

SCO Group - President, Chief Executive Officer

Robert Bench

SCO Group - Chief Financial Officer

CONFERENCE CALL PARTICIPANTS

Stephen Shankland

CNETNews.com - Analyst

Matt Kelly

Deutsche Bank - Analyst

Herbert Jackson

Renaissance Ventures - Analyst

Dion Cornett

Decatur Jones Equity - Analyst

Peter Galley

- Analyst

Paula Rooney

CRN - Analyst

Larry Solomon

Capital Guardian Research - Analyst

Kevin Blark

Computer Wire - Analyst

PRESENTATION

Operator

Good day and welcome to the SCO Group conference call. Today's call is being recorded. At this time, for opening remarks and introductions, I would like to turn the call over to Mr. Blake Stowell. Mr. Stowell, please go ahead, sir.

Blake Stowell - SCO Group - Contact

Thanks, everyone, for joining us today. As many of you are aware, there was an announcement that went out yesterday. That's why we're all here.

We will start our call off with a statement from our President and CEO, Darl McBride. Mr. Bob Bench, our CFO, is also joining us on the call today, and both will be available for a Q&A session following Darl's remarks.

With that, we will turn the time over to our President and CEO, Darl McBride.

Darl McBride - SCO Group - President, Chief Executive Officer

Thanks, Blake. As Blake said yesterday, the SCO Group closed and announced a \$50 million private equity investment led by BayStar Capital. We're glad to have BayStar on as an equity partner with us, and we are pleased especially with the structure of the transaction, which we believe to be very favorable to the Company and to our shareholders.

So, let me go through the details of the transaction with you for moment. The first point -- the investment was structured as a private placement of nonvoting Series A convertible preferred shares. The shares are convertible into common equity at a fixed conversion price of \$16.93 per share. The way that we arrived at the conversion price was by averaging the closing bid price for the Company's common stock for the five trading days prior to the closing transaction, which happened yesterday.

So, upon conversion, the investors will own an aggregate of approximately 2,953,000 shares of SCO common stock, representing 17.5 percent of the Company's outstanding shares. There is no dividend payable to the preferred shareholders for the first 12 points of this deal. Beginning on the first year anniversary, the holder will be entitled to a dividend payment of 8 percent per annum payable quarterly, which can be paid in cash or in stock at the Company's election. The dividend payment will increase 2 percent per annum in years three and four and ultimately be capped at 12 percent.

The Series A preferred share carry a liquidation preference equal to the original issue price of the shares plus the greater of 8 percent or a market value formula. The Company has agreed to promptly register the common shares into which Series A shares are convertible. The Series I preferred shares will be registered.

So that's the basic rundown on the terms of the deal. The net proceeds, combined with our previous cash position, as reported for our previous quarter ended in July, provides the Company with the combined cash position of approximately \$61 million. As I mentioned before, we're very pleased with this transaction. This equity investment strengthens our balance sheet significantly. It also provides additional resources for pursuing SCO's business objectives. The

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1

FINAL TRANSCRIPT

SCOX - SCO to Comment and Provide Q&A on the Oct. 16th Investment Announcement

additional capital should help accelerate our SCOX (ph) Web services effort, our growing vertical markets initiative, our legacy UNIX businesses and our SCO source IP enforcement and licensing activities.

For more information on the transaction, the stock purchase agreement, the Certificate of Designation, registration rights agreement -- they're all attached to our 8-K filing, which went out within the last hour. So, I invite all of you to review our filing attachments for additional details.

With that, why don't we go ahead and open the call up for whatever questions you might have?

QUESTIONS AND ANSWERS

Operator

Thank you, sir. Today's question-and-answer session will be conducted electronically. (OPERATOR INSTRUCTIONS). Stephen Shankland of Cent (ph).

Stephen Shankland - CNETNews.com - Analyst

This is Stephen Shankland from CNETNews.com. I was wondering, last May in the conference call after earnings, you guys said that you had been looking to raise equity capital; people were ready to invest and then you decided not to "because we were able to generate larger amounts of cash from a SCO source that were nondilutive." So I was wondering what led to the reversal of course here.

Darl McBride - SCO Group - President, Chief Executive Officer

It's a good question. I noticed you had that in your article yesterday, and it's a good question. The raising of capital right now is a little bit -- it goes back to the old analogy, it's easiest to raise money when you don't need it. That's really the situation that we're in. We're in a very strong position; we're accreting cash; we tripled our cash balances over the last two quarters, and projecting more to come. So, it is a good question. If we are accreting cash, things are going well and why take the dilution?

I think it's interesting, if you look from a perspective of where we are from our market capitalization right now and the small amount of dilution we were able to take for a \$50 million raise, from a SCO shareholder perspective, the ability to build

a war chest at this point in time was just too compelling to pass up. We actually weren't even out looking for capital right now (sic) -- in the process of going on some various investment discussions on Wall Street and West Coast trips, we actually had people approaching us saying "Could we buy some shares? Could we get into a private placement with you?" Actually had four or five different groups that were interested in getting into this. We ended up sitting down and looking at where our current market capitalization is and said, "this could be very valuable to the Company, so let's pick the best option there and move forward."

If you look at where the stock was in May, Stephen, you know it was sub \$10, \$6; I'd have to go back and look exactly, but if you look at the amount of dilution we have taken on a \$50 million raise back then, it would've been significant. If you look at where we were a year ago, you know, right after joining the Company, we had an opportunity to buy some shares back. You look at the shares we bought back at that point in time -- 4.3 million I believe it was at 93 cents a share -- a little over a year ago. Now, we've turned around and issued about 2.9 million shares, 2.95, whatever that number was, at, you know, just under \$20 a share. So, from a shareholder standpoint, we think this is good all the way around.

Stephen Shankland - CNETNews.com - Analyst

Also, just one point on the conversion into common stock -- at what point does that happen from the Series A preferred to (indiscernible)?

Darl McBride - SCO Group - President, Chief Executive Officer

Right. Bob, do you want to go through the details of how that works from a timing standpoint?

Robert Bench - SCO Group - Chief Financial Officer

Sure. Steve, that can occur immediately; there is no timing on that. We will be registering those shares as quickly as possible under an S-3, so those are immediately convertible.

Operator

Matt Kelly of Deutsche Bank.

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2

FINAL TRANSCRIPT

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Matt Kelly - Deutsche Bank - Analyst

Just a quick question about the decision making behind going the outside route through a pipe with BayStar, versus having, say, Canopy increase their position or accessing the public markets.

Darl McBride - SCO Group - President, Chief Executive Officer

Sure. We looked at a variety of different vehicles. One of the things that was very compelling to us regarding the BayStar vehicle was their very strong track record. If you look at other deals that they've done with companies that were in the public marketplace that took these types of (Indiscernible) transactions, they are in BayStar's portfolio; they have performed very well. You look at companies such as XM Radio, XMSR. If you look at SIRI -- SIRIUS radio -- the kind of performance they had post-BayStar investments, it was very appealing to us. You know, also just the breadth of reach they have in the industry -- they are strong in the tech marketplace, so it was very attractive and very appealing to us.

Matt Kelly - Deutsche Bank - Analyst

Thanks a lot.

Operator

Herbert Jackson of Renaissance Ventures.

Herbert Jackson - Renaissance Ventures - Analyst

Congratulations, guys. Can you give any color to the strategic partnership initiatives that you've alluded to in the release?

Unidentified Speaker

I'm sorry, looking at something else. The partnerships alluded to in the release?

Herbert Jackson - Renaissance Ventures - Analyst

In terms of use of proceeds.

Unidentified Speaker

Yes. As we go forward, we have multiple opportunities here in front of us. You start with our core business. If you look at the UNIX business, it's very interesting. You see over 2 million servers active and running out there today. I spent a lot of time over the last couple of months going out and meeting with customers. We've got a very strong install base of SCO UNIX out there running today. We've come back, in the last two months, to our installed base and said, "we're going to keep moving this product along." We came out with a new product announcement at SCO Forum around OpenServer and the continuation of OpenServer. The customers are very happy with that.

We recently had the longest running server contest, and we had one server out there that had not been down for 20 years. You know, that's the type of quality products we're dealing with. So the fact that we're saying we've had products that have been running for 20 years; now we're going to refresh them and go forward and they're going to run again for 20 more years with a new upgrade -- our customer base is very excited about. So that's really the starting point.

The next thing we go to is the Web Services play, where we have the ability to go in and then put a wrapper of Web services around these operating systems that we have. We have various discussions going on there that we're very happy with how some of those discussions are going currently.

Finally, obviously the thing that gets a lot of media attention right now, even though we have a very small percent of the Company working on the project, is SCO Source, but clearly, there are a lot of opportunities for the Company as it relates to enforcing our intellectual property rights. The two major operating systems in the world, UNIX and Windows, you know, SCO owns one of those. Having the ownership around the UNIX operating system is just a gigantic marketplace opportunity for us. So, we're not here today to spell out how it's going to be allocated across the various buckets, but we are looking at growing the Company; we will have this war chest in place to be able to take the Company forward in a way that is extremely valuable to SCO, its customers, employees and shareholders.

Operator

Dion Cornett of Decatur Jones.

FINAL TRANSCRIPT

SCOX - SCO to Comment and Provide Q&A on the Oct. 16th Investment Announcement

Dion Cornett - Decatur Jones Equity - Analyst

I think this is a good deal for the Company (inaudible). Just a couple of quick questions about some of the features of the security. Does BayStar have the right to do partial conversion? Is there any minimum size or period in between when they are allowed to do that? When does the redemption feature kick in? What remedies are available if SCO is not in a position to redeem the invested capital (indiscernible) interest?

Robert Bench - SCO Group - Chief Financial Officer

Yes. Thanks, Dion. As far as conversions, they can begin to convert immediately. The agreement calls for a minimum of 100,000 common shares to be converted at a time, so hopefully that answers your first question.

The second, as far as redemption, there's mandatory redemption once the stock price has reached 150 percent for 20 consecutive trading days, and then it's mandatory that they convert to common stock. There's also -- the Company has redemption rights as far as after three years, the Company can redeem the stock with a liquidation preference. So, the Company has a lot of freedom to redeem this stock as they need to if BayStar has not converted.

Dion Cornett - Decatur Jones Equity - Analyst

Honestly, BayStar was not one of the firms I worked with previously in my prior equity experience. It's just their style to sort of hold their option value to the (indiscernible) or might they I guess trickle some common stock out into the market to provide some higher liquidity for you guys?

Robert Bench - SCO Group - Chief Financial Officer

Yes. One of the reasons for working with BayStar is they are very helpful in doing just that, and as anyone who has watched our stock -- we certainly need to increase the liquidity out there and we're very happy that we have a partner now that we can begin to do that with.

Dion Cornett - Decatur Jones Equity - Analyst

Just having you guys on the phone, any comment on how the quarter is tracking?

Robert Bench - SCO Group - Chief Financial Officer

We haven't made any changes to our earlier guidance, Dion.

Darl McBride - SCO Group - President, Chief Executive Officer

The one other thing I would say with respect to liquidity -- that is a tricky game. You like liquidity when it's in the right way! The thing that we got a lot of comfort around was the track record of other companies that had taken similar investments in BayStar. Again, you look at XM radio, you look at some of these companies and how they performed. That's why we're thrilled to have BayStar as an equity capital partner with us on this.

Operator

Peter Galley (ph) of -- (technical difficulty) -- Magazine.

Peter Galley -- Analyst

I was just wondering, there seems to have been a little bit of a back-off from your perspective on the litigation, particularly against Enterprise clients. You talked about sending out invoices. That plan seems to have been put on hold. Also, at your conference earlier this year, you were talking about, actually, potential litigation against a single Enterprise client; that seems to have been put on hold or not happened at all. Does this investment actually reduce your intentions to continue with that litigation? What are your plans with that regard?

Darl McBride - SCO Group - President, Chief Executive Officer

Yes. Good question, Peter. The investment is really independent of our plans and actions with respect to how we enforce our intellectual property rights. I would say that it strengthens and bolsters us.

If you go back to our conference call in July when we talked about coming out with a licensing program and going out and enforcing that, one of the things that we talked about was we wanted to give customers a chance to step up and work with us. Again, the reason we put the licensing plan in place was because customers asked for it. So, the plan was rather I'm just going out and finding a bunch of customers and start dropping lawsuits on them, the idea really was look, here we have some intellectual property problems that we see inside of Linux today. We're here to be reasonable; we're

FINAL TRANSCRIPT

SCOX - SCO to Comment and Provide Q&A on the Oct. 16th Investment Announcement

putting a solution on the table. To the extent that that works, then that would actually be our preferred path. We bifurcated around people that are going out and using it for commercial use as opposed to individual users. We're not trying to track down people using Linux at home, in their garage, wherever they may be; we're talking about people who are getting benefit from our IP in commercial installations. So, we sent out the letter to the large corporations, the global 150. We're now in the process of following up with them. Quite honestly, Peter, we're getting very good feedback. We're signing up additional deals; we have a pipeline that building that's healthy, and so as we go down the licensing path and these discussions continue to bear fruit, our goal is not to go out and start suing companies. But -- as we go down the path, if we get to that point or we have certain customers or companies out there that are using Linux and we are unable to come to a resolution or reach an impasse, we absolutely will reserve the option to have the legal path as a remedy to go resolve that.

We did announce that we had extended the pricing period -- going from 699 up to 1399 through the end of this month. You know, this is the end of our quarter; it's the end of our fiscal year. We actually like how things are dialing in right now. We're having very good traction with our licensing discussions; we know have this 50 million on the balance sheet; we're getting ready to start a new fiscal year. As long as people are licensing up then we're in great shape. If we have problems and we reached an impasse, then as we get into the new fiscal year starting November, then we will have to see where we go from there.

Peter Galley - Analyst

Okay. One other question -- I don't know if you saw that survey which came out which said that 80 percent of businesses and enterprises were completely unphased and unaffected by your stance on Linux and were continuing to go ahead with their Linux implementations. Does that concern you at all?

Darl McBride - SCO Group - President, Chief Executive Officer

Well, I think the one thing that it says is that in a short six-month period of time since we've been talking about this, you now have 20 percent of the people that I guess by definition (indiscernible) that are saying they are concerned. So, I think, for the short amount of time that we've been talking about this, I would interpret from that that there are people that are concerned about it.

I can tell you for being out and meeting with large customers -- with global 1000 type customers -- that there is no doubt there is some impact in the marketplace. Again, we're trying to help resolve that and then help people move forward. You know, I'm sure there are people out there taking a stance that they are going to wait and see what happens. I think, as more people do start licensing up and as we move down the road, if people don't license, if we do end up in a court setting with some customers, that will probably have an impact. But right now, we feel very good about where we are; we're getting the right kind of response from the customers we're talking to that are running Linux, and we're just going to continue down that path.

We're not trying to run a sprint here. We're not wanting the 100 yard dash; this is probably a marathon and we are in it for the long haul.

Operator

Paula Rooney of CRN.

Paula Rooney - CRN - Analyst

I'm wondering if you could shed some light on possible negotiations with IBM, and if there's any possibility of a settlement in the next year, or is that just completely out of the question?

Darl McBride - SCO Group - President, Chief Executive Officer

You know, over the last -- the other thing we've done over the last several months is we have met with a number of major industry leaders. I can't get into details of who we've met with and what discussions have been had, but we don't rule out the possibility along the way of trying to reach some type of a global settlement around these issues. I think it's in fairness to IBM, this is not just an IBM issue. I mean, clearly, a lot of our energies are centered around that from a legal standpoint, and they've fired back at us with some counterclaims and that's sort of the center of the coliseum, if you will, that everybody's watching. But clearly, there are other issues here that have impact other players. So, you know, to the extent that you're going to talk about some kind of a settlement that resolves an entire industry set of problems, then there probably has to be an entire industry trying to figure out how to solve this. So, you know, we would continue to entertain those discussions as they come along,

FINAL TRANSCRIPT

SCOX - SCO to Comment and Provide Q&A on the Oct. 16th Investment Announcement

but in the meantime, we're not going to hold that as a plan of resolution. If we don't get there, that's -- we're trying to go independent and we're trying to go down and get all of this resolved and move toward as an independent.

Paula Rooney - CRN - Analyst

Could you tell us what the status is of the current lawsuits with IBM and also the Red Hat issue?

Darl McBride - SCO Group - President, Chief Executive Officer

Right. Yes, so in the Red Hat case, we are back and forth there in Delaware. We've filed a motion to dismiss that case. So that's going through there, and I expect, over the next coming weeks, month, whatever, we will hear something with respect to whether the Motion A get dismissed or if it gets heard. If it does get heard, we're actually fine with going in and laying down basically -- the only hurdle we have to get over there is to show that we have a valid claim to be making against IBM; that's the main thing that they're looking for is for us to say, this is something you guys should be claiming. Fine; we will get there one way or another.

With respect to IBM, you know, about one is -- in kind of the claims/counterclaims response mode. I expect, within the next week or so, we will have additional things coming out on that.

Operator

Larry Solomon of Capital Guardian.

Larry Solomon - Capital Guardian Research - Analyst

Yes, it sounds like you're already making license revenues from Linux. To the extent that that is quantified, is that something that BayStar was aware of when the made this investment?

Darl McBride - SCO Group - President, Chief Executive Officer

BayStar did a full level of due diligence on our company. They understand the opportunities that we have, and so whatever we're sitting on (indiscernible) they certainly would have a good understanding of our current business operations.

Operator

Kevin Blark (ph) of Computer Wire (ph).

Kevin Blark - Computer Wire - Analyst

It's actually Gavin & Cloutte (ph). I wanted an update on what was going on with SGI. I know that there was a -- I think there was a deadline of October 14th in which they had to kind of respond to some of the issues which SCO raised. I wonder (indiscernible) I wonder if there's going to be fresh deadline on that, or if you are in talks with SGI to resolve your kind of differences.

Darl McBride - SCO Group - President, Chief Executive Officer

Yes. Thanks, Kevin. We do have discussions going on with SGI. We are working through issues; we have agreed to hold tight on any kind of rescinding of contracts anything of that sort while we work through these issues. We are pleased with the behavior that SGI has had during this period of -- cure period 60 days that we issued from the middle of summer until October 14th. They did come out and announce publicly that they had removed a couple hundred lines of code out of the Linux CodeBase. So, we are pleased with the discussions that are going on there. We do not have a final resolution to talk about today, but we will continue to engage with them in those discussions.

Kevin Blark - Computer Wire - Analyst

Can we expect any more kind of -- (indiscernible) further action against other big-name companies? Are you considering (indiscernible) kind of companies in the near future like SGI?

Darl McBride - SCO Group - President, Chief Executive Officer

With respect to UNIX licenses or end-use customers of Linux?

Kevin Blark - Computer Wire - Analyst

UNIX licensees.

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6

FINAL TRANSCRIPT

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Darl McBride - SCO Group - President, Chief Executive Officer

Yes, we don't see anything else on the horizon that is troubling to us at this point in time as it relates to vendors on the UNIX side. We do have a concern -- an issue. We have over 6000 UNIX licensees at the end-user level that the license contracts we have on UNIX actually give us some protection against those that might be using Linux that are out there. So those are the areas that we are currently investigating. As we're looking to resolve our issues with Linux and the areas of infringement that we see going on there, when you double that against a UNIX contract that a large end user may be holding, you know, that does give us some additional strength from an enforcement standpoint.

Operator

That is all the time we have for today's question-and-answer session. At this time, I'd like to turn the call back over to Mr. Darl McBride for any additional or closing remarks.

Darl McBride - SCO Group - President, Chief Executive Officer

Okay. First, before I give my remarks here, Blake -- I know we need to read some of these forward-looking statements here, just from a closing standpoint.

Blake Stowell - SCO Group - Contact

We would've taken care of this at the beginning of the call. We were reminded of this and I'll now go through those forward-looking statements.

This press announcement contains forward-looking statements related to our business plans and objectives and specifically to our plans for future UNIX and SCOX (ph) Web services software development, protection of our UNIX electoral property, current and future licensing programs and strategic initiatives, future product and service offerings, our intent to provide further details on our plans and initiatives and our belief that the additional funding we received will fund all aspects of our long-term growth of the Company. These statements involve risks and uncertainties.

The company wishes to advise readers that the number of important factors could cause actual results to differ materially from those anticipated in such forward-looking statements. The Company has a history of unprofitability and has only realized revenue from its SCO Source licensing initiative

during the last two quarters and the intellectual property rights that it is asserting and seeking to enter (inaudible) licensing agreements are subject to pending litigation, making it difficult to predict the extent of future revenues from this source.

Other factors that may affect such forward-looking statements include the ability of the Company to successfully roll out its new services and solutions to service providers in its existing channels, the acceptance of such offerings by existing service providers and customers, the ability of the Company to grow its core UNIX business and the continued acceptance in the marketplace of the Company's core products, the Company's ability to compete effectively with other solution providers, new and changing technologies and customer acceptance of those technologies, and claims of infringement on third-party intellectual property rights. These and other factors that could cause actual results to differ maturely from those anticipated, are discussed in more detail with the Company's filings with the Securities and Exchange Commission.

I will now turn the time over to Darl for closing remarks.

Darl McBride - SCO Group - President, Chief Executive Officer

Just a couple of points to clarify -- again, going back to BayStar and our decision to go there, the track record they had in the marketplace has indeed been stellar with a number of technology companies. We have had strategic discussions with them. You know, the question came up earlier about what do they know as far as the licensing and different things? We've had preliminary discussions, not definitive, around strategically where we are going. Indeed, we're both enthused about the prospects that are held for the Company. The momentum in the marketplace we believe continues to build for SCO.

We've been making progress throughout the year on multiple fronts. The progress has been with SCO Source intellectually property enforcement efforts. It's been with our legacy UNIX businesses -- reinvigorating our SCO brand we rolled out a year ago and the major initiatives for the future, such things like SCOX (ph).

We've seen great improvements in our operations. We've seen strong improvements in our bottom-line as well as in our share price reflected over the last year.

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7

FINAL TRANSCRIPT

SCOX - SCO to Comment and Provide Q&A on the Oct. 16th Investment Announcement

SCO believes in the value of intellectual property and the value of proprietary software. We believe that software developers and software companies should be paid for their work product. We believe that profits are good, not just for companies but for the growth of industries, and we are working hard to deliver that value for our company and for our shareholders.

As I said earlier, when repurchased these shares, 4.3 million shares, a year ago for \$4 million. Yesterday SCO closed on an equity financing selling 2.9 plus million shares for \$50 million. We've made great progress in a year. We have a lot more work ahead of us, but we are all excited to go forward with this new war chest that we have behind us and believe we are well on our way to going to the next level of success.

Thanks for joining us on the call today.

Operator

Once again, that does conclude today's conference. You may disconnect at this time.

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8