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KITD - Q4 2011 KIT digital Earnings Conference Call

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PRESENTATION

Murray Arenson - *KIT digital, Inc. - VP- IR, Corporate Development*

Good morning, everyone, my name is Murray Arenson, Vice President of Investor Relations and Corporate Development with KIT digital. Thank you for joining us today to discuss our Company's fourth quarter and year-end 2011 results for the period ended December 31, 2011.

First a technical note. If you're watching a video webcast and have also dialed in to participate in our Q&A session following Management's presentation, please place your phone handset down now and until the Q&A session begins and listen to the call through your computer speakers. This will help avoid confusion from the necessary audio lag between the online streaming and you're phone line. I should also add that today's Q&A session will not be webcasted, so if you would like to listen to the Q&A or ask a question, please call the number on the screen before the beginning of the Q&A session.

I'd also note that on your screen on your browser in the lower right-hand corner is an opportunity for you to e-mail questions at any point during the broadcast. At the end of our presentation, we'll pause momentarily to allow callers to dial in. In case you missed any portion of today's presentation a complete video and audio replay will be made available via the investor relations section of our website. Or you may listen to a replay over the phone by following the instructions in today's press release.

Now to our presentation. Joining us today is our Chairman and Chief Executive Officer, Kaleil Isaza Tuzman, our President, Gavin Campion, and our Chief Financial Officer, Robin Smyth. Following their remarks we'll open up the call for your questions. Then before the conclusion of today's call, the Operator will provide the necessary precautions regarding any forward-looking statements made by Management during this call.

I'd now like to turn the broadcast over to our Chairman and CEO, Kaleil Isaza Tuzman. Kaleil?

Kaleil Isaza Tuzman - *KIT digital, Inc. - Chairman, CEO*

Thank you, Murray and good morning, everyone. As you saw we issued a press release this morning with our fourth quarter and full-year 2011 results. We'll be filing our 10-K early next week. The organic growth in our business is reflected in these record results. We grew Q4 over Q3 organically with no impact from acquisition of about 12% sequentially which annualizes to over 50% growth. And we notched new tier 1 contracts in all three of our regions, a few of which Gavin will speak to momentarily. On today's call we're going to frame the opportunity presented by our market in slightly different ways that we have in the past. I'm going to reiterate why we believe our business is so well placed to lead our market globally. But first I'd like to invite our CFO, Robin Smyth, to take us through the highlights of the quarter and the full year. Robin?



Robin Smyth - *KIT digital, Inc. - CFO*

Thank you, Kaleil, and good morning, everyone. I'll use this time to draw your attention to some key financial highlights from our fourth quarter and full-year 2011. Please refer to this morning's press release for more detailed financial data and results. As Kaleil mentioned, we'll be putting out our 10-K early next week as our auditors needed more time to verify valuations of intangibles on our acquisitions made during 2011.

Onto the quarter highlights. Revenue for the quarter was \$70 million compared to \$62.3 million for Q3 and \$38.4 million for Q4 2010. This result was approximately \$3 million above our original guidance for Q4. We reported \$215 million for the full year 2011 versus \$107 million for the full year 2010. Non-GAAP operating income, what we used to refer to as operating EBITDA, was \$16.5 million, an increase of 15% over Q3 and in line with our preliminary results communicated several weeks ago but below our original guidance of \$17.5 million for the quarter. As we have said previously, this was related to additional investment in staffing for new tier 1 client implementations in the quarter. During the full year, non-GAAP operating income, or operating EBITDA, increased 152% to a record \$47.4 million from \$18.3 million in 2010.

Cash-based adjusted EPS for the fourth quarter was approximately \$0.36 higher than our previously guided figure of \$0.33. Cash and cash equivalents as of December 31, 2011 were approximately \$48 million. It is important to note that this was after \$10.5 million in acquisition consideration paid out in the quarter and about \$2.5 million paid out in tax payments related to our acquisition of ioko in the first half of 2011. Common shares outstanding at the fourth quarter ended were 46.35 million shares. While we continue to expense rather than capitalize R&D as an accounting policy, we plan to report R&D expenses in our public filings starting in 2012. We estimate that our R&D expenses currently represent 6% to 7% of our revenues. Murray will be addressing our forward financial guidance shortly. Now I would like to hand over to-- the presentation to Gavin to discuss Q4 operational highlights. Gavin?

Gavin Campion - *KIT digital, Inc. - President*

Well thanks, Robin and Kaleil, and hello, everybody. As Robin mentioned, our record results reflect increasing demand in the market. We have approximately 2,500 customers across 50 countries using the KIT Video platform to manage and deliver video. We have a balanced and diversified global client base where no single client accounts for more than 5% of our total revenues. We continue to focus on what we call tier 1 accounts, large-scale deployments who utilize the full breadth of functionality offered by the KIT Video platform. We added more than 35 net new client contracts during the fourth quarter. We've estimated average monthly revenue per client in excess of \$36,000.

You can find a detailed list of new client wins in our press release, new clients like Grupo Clarin, Iusacell, RTE, all market leaders in their respective regions. We deployed Channel 4, Channel 5 and a number of other broadcasters and network operators in Europe and in Asia on the Microsoft Xbox. The application allows users to control their television experience with gestures and with their voice. OSN, the Middle East largest satellite TV provider, chose KIT digital to deploy the first ever over the top VOD and live TV platform in the region. The deployment will set a benchmark for entrance to the market in years to come and be a catalyst for the market growth. And we've talked about a scaling our business through partnerships. And I'm pleased to say IBM was added as a key new technology marketing and deployment partner for the KIT Video platform.

As an external platform vendor, we more tier 1 OTT video implementations than any competitor worldwide. We recognize that content owners, broadcasters and network operators are racing to own the consumer and we foresee record growth in coming quarters and emerging markets like Latin America, the Middle East and Southeast Asia. To this end we are investing in our business. We have earmarked an investment of around \$16 million this year in sales and marketing, research and development and performance management initiatives. We're also undertaking a rationalization of certain offices and client service centers that is expected to generate savings of up to \$10 million by 2013. Part of this effort involves extending ISO accreditations to all of our major R&D centers last year which was actually successfully completed in Q4.

I wanted to spend a couple of minutes explaining why we are so excited about KIT digital's leadership position in this market, in a market that is demonstrating ferocious growth. The way people consume video has changed. IP video will go from just under 10% of total video consumption to 75% by 2020, that's 75% of all television consumed globally. People use more and more connected devices. For example, by 2014 there will be almost as many broadband connected TV sets as there are PCs. This game won't be won by a traditional small online video platform provider. Investment in infrastructure is enabling this revolution. According to Screen Digest, there will be 680 million broadband connections by 2014.



So what's this market worth? While different analyst address it in different ways, but they all come in around \$10 billion to \$15 billion value dollar mark, most of which has been in traditional digital. What we have here is entire generations for whom television means something very different than what it used to. Not unlike other categories such as print medium, books and the obvious one, the music category. On-demand TV on any device at any time has become the preference of consumers.

Consider how content got to consumers in the past. Previously, content producers like Universal would pass content to broadcasters like say ABC. In this case, the distribution was facilitated by infrastructure and service companies like Sky for example, and was finally presented to the end user on television, lets say on an LG device. Now all constituents are aggressively seeking to own the end customer and broadcast TV to them directly over IP. What's more, end consumers the viewers are seeking video from all four premier broadcasters like Netflix, from content producers, from existing relationships with service providers such as AT&T's U-verse. We have often say that there is now an industry war going on to satisfy this consumer demand. KIT digital is able to act as a white label arms dealer, if you like, to all of these companies as they battle to win end users.

And let's not forget the fifth player, the enterprise. Physical using video for internal trading, education, internal communication, security applications et cetera. The KIT Video platform serves all five groups and is doing so as we speak. While as we sometimes get mentioned in the same breath as the online video platform providers, we are very confident that we have the best technology for these tier 1 customers seeking broadcast grade five [times] reliability and multiple integration points into existing BSS and OSS systems. The KIT Video platform supports complex management of rights, payment rules and permissions associated with the content and publishes it to over 500 devices. And in fact is doing so right now to tens of millions of simultaneous users.

KIT is focused on these tier 1 opportunities at the forefront of the broadcasting market as it transforms to IP as consumer demand stipulates and as the categories I mentioned speak to our own TV audience of the future. It doesn't come without its operational challenges. Picking the right clients in the right marketplaces, scaling the business through quality recruitment and partnerships as I mentioned earlier, some selective investment in the future opportunity, undertaking M&A for the scarce high-quality implementation resources especially in immature marketplaces. But we win profitable tier 1 clients as evidence in Q4 with the best capability in the marketplace. The KIT Video platform makes for the market leading team to deploy and support it. So with that, I'm going to hand over to Kaleil, who with Murray, will take us through our current and future financial profile. Thank you.

Kaleil Isaza Tuzman - *KIT digital, Inc. - Chairman, CEO*

Thanks, Gavin. We're going to spend now a few minutes really re-educating some of you, and for those of you that are new to this story, walking through how our revenue streams work, how a simple contract in our business works and also helping you dissect organic versus inorganic growth because that's a question we get a lot about our business given our history of a number of acquisitions over the last 4.5 years.

So I want to start by talking about our different revenue streams. We have as a lot of software as a service company-- companies have and enterprise software companies in general have three different areas of revenue generation. One, we call an access fee or a licensee fee, sometimes we'll call it the base fee and that's what we're paid in almost all cases monthly, sometimes quarterly, for access to the system irrespective of level of usage. And today you can see from the slide on your screen in aggregate it represents something in order of about 33% of revenues or \$0.33 out of \$1 of revenues on average. And we're going to talk in a minute about how these streams evolve over the lifetime of a contract, but this is across all of our approximately 2500 clients.

Secondly, and we're kind of tiling up from the base and the slide on your screen, you see the blue is what we call utilization fees and if it's a really big tier 1 customer like an AT&T or a Liberty Global or a BSKyB often this will be referred to as managed services because that's kind of the language of the service provider community. But these fee-- and then if you talk that mid tier and smaller customers, it'll be more per unit. It might be based on number of subs or number of we use a proxy sometimes, like bandwidth or storage even if we're not actually building that through because unlike small online video platforms, we don't actually resell bandwidth or storage as any kind of material part of our business, but we will use that as a proxy to measure usage. And as I said in the larger clients, that managed services fee is done often by tiers of 50,000 or 100,000 subs or amounts assets in the system that's more tiered in more of a step function way.



But in any event, these utilization fees today represent about 36% of revenues and that base fee plus -- and these are by the way Q4 annualized figures, so it's been bumping around 65%, 75% of our revenues between base fees and utilization fees together for over four years. So right in that range, people are-- we were around 69% of revenues and that is really the recurring revenue portion of our business that we go into each quarter with and that's contracted. The base fees are contracted years in advance, the utilization fees we have a lot of history on and the utilization fees because of increased bandwidth, connectivity, 4G and LTE mobile capability devices that are introduced in the market it goes up typically about 2% per month, the exception of a couple months that are down in the northern hemisphere summer like July and August, and then January is typically down a little bit over December given in the Judeo-Christian countries the great boom in digital media consumption in December. But in general, utilization fees you should think about going up around compounded up the account for some minor attrition at 25% or thereabout per annum.

And then on top of that you have the discretionary professional services fees which today is running as it has historically around 30% as to be precise Q4 annualized basis about 31% of revenues. And this is revenue that really behaves like recurring revenue, it's still very highly visible for us. Some of it's contracted into the future through statements of work generated by an implementation obviously but also a lot of integration into other systems of record like billing systems and CRM systems, web CMS systems, authentication, conditional access and other firm ware systems, and all this generates professional services fees for us for the over 800 people on staff that are involved in client services, creates a lot of privity with clients is really I think the envy of the industry and allows us to have these deeply embedded relationships. It isn't contractually guaranteed, but it has a high level of correlation utilization fees.

Now we're kind of a mix of a high margin business and a low margin business. The 7% or so of fees that are the platform fees related to software and managed service component are very high margins 80% plus margin. The professional services are 15% to 20% margins and that's pretty normal with enterprise software type of provision, in our case platform is a service where you really have that mix of margins characteristics.

Now here what we've done on this slide is giving you a sense of how a client evolves over time. We get this question a lot so people can understand when we talk about as we did in Q4 having some additional investment around some implementation why that's so exciting for us in terms of future revenue and cash generation. So you have these three streams again that are represented on the slide, the base license fees, the utilization fees and service fees. Now in the beginning of a client life cycle, you've got some of that license fee component even if the system is not yet lit up and even if there aren't users yet on what might be an OTT platform for an MSO or telco or what have you and you've got a lot of services. You got kind of a bulk of services revenues that over anywhere for the first 6 months, the first 18 months of a client are going to be a significant portion of the revenues associated with that client as we're implementing the system and integrating the system with other systems of record that exist, again billing and identity and CRM and CMS et cetera.

What happens is over the life of that client as the years pass, the utilization fee increases and eventually becomes the majority and even a significant majority of the revenues and so the margin profile improves over time. So you see that with an AT&T for example, where over four years working with AT&T it's one of our largest clients of course supporting the U-verse platform and today the managed services kind of tiered utilization component is a very significant portion of our work with them of that's natural as a client evolves.

So you should really think about it as an investment up front. You're making \$1 of investment for example in services, you maybe make a very thin margin in the beginning of that client life, but then you are getting much higher margin over the life of the client. And again, our attrition rates and Murray's going to introduced some new operating metrics for us to go on from 2012 going forward shortly, one of them has to do with churn. We've had churn on a revenue basis of anywhere between 1% and 2%, typically closer to 1% per annum over the last four years and I want to kind of knock on wood as I say this but we never lost a tier 1 client. So it's very embedded once the system is in place and we take great pride in the great work that our client services team does in really keeping the client close.

Now this slide is addressing the question that many of you have had over time on how do I understand the KIT digital, what is organic and what is-- organic growth and what is growth by acquisition? And what we've done here, and this presentation will be available on a VOD basis on our website, you can look at these numbers more carefully and build them into your thinking and you're modeling, we've taken the pro forma revenues for each of these periods 2009 through present, we can also 2008 it's just a very small number, and what we've done is taken the contribution from the acquisitions that we made during that period and annualized that to give you a pro forma for acquisition figure, which is giving you both the blue and green bars together. And then to measure the organic growth in the following year obviously you can separate out what we required



pro forma from acquisitions through that year and just strictly look at the organic growth component. And what you see is exactly what we've been telling the market for years, we consistently have the feedback is difficult to do the analysis.

Now all of these numbers are in the public domain and press releases that we've done in the past, but we've aggregated here for ease of reference and what you'll see is that natural progression of a high growth software or software as a service company where you have it when we're earlier stages of revenue when you're around \$50 million of revenue growing at 50% not unlike a Brightcove for example that recently went public around that level. And then that growth level has gone more into the 30% and as we socialize for 2012, 25% to 30% type of organic growth as a baseline just as a dent of the Company getting larger and also us wanting to be a little conservative around the growth. But we do see over the long term really strong 20% plus organic growth in our sector given the burgeoning number of devices, bandwidth connectivity both in the fixed line and mobile environment, and most importantly behavioral changes, Gavin was talking about this before, as people really embrace having their content in different devices on a single sign on -- single subscriber relationship and really demand content when they want it, where they want it.

Now we're now going to talk for a minute about how do you get comfortable around the revenue expansion guides that we've given, how-- and really give you a little bit of a lens into how we think about, how we model and plan our business. And it's a bit hard to digest, a lot of info on this slide, but this revenue bridge shows you in this case from our business planning perspective organically, just purely organic, how we got from 2011 numbers to 2012 guidance. And what we start with is our Q4 annualized run rate. And what you see here in the orange, green and blue columns are the different three streams I talked about before, the base licenses, the utilization fees and the professional services fees. The base license as being in orange, the utilization fees being in green and the professional services [ala carte] being in light blue.

And it shows you we're starting the year, we're going into 2012 with \$91 million, call it \$90 million, of base license fees and that's contractual totally recurring revenue that goes through the year. Then you've got \$102 million, call it \$100 million, of fees that are utilization fees, and that's again per unit, it could be based on amount of bandwidth being consumed or storage, it could be based on number of video assets, we call them assets from our video files so to speak being held in the video platform database, it could be based on number of authentication events, number of times subscribers go in, number of subscribers et cetera and tiered numbers through managed service type contract, and that also recurring. So we're going into the year with about \$190 million, north of \$190 million of recurring revenue that we know we will stay with us through the year. And again this just on our existing customers.

Then you've got a professional services fees that annualize about \$88 million, let's call it \$90 million, of revenues that our customers are now spending on professional services. Anywhere between 20% and 35% of this in a given quarter might be implementation, but a lot of it again remember off of around 2500 clients are just service requests that come up, changes in user experiences that our clients want other systems of record like ERP systems, CMS systems that are introduced that we have to integrate with. So there you have now are what we call are highly visible revenues coming in the year which coincides of course with the annualized rate of Q4.

Now in terms of same-store sales, or our existing client base growth, we break that again down into the licensed fee, the utilization fee and the services. And we find as I referred to before that little orange bar that you see there, we assume say another 7% or 8% that's net of attrition growth in the license fees from new device support, some contractual escalators, some modest pricing power we have upon renewal, you then see around \$18 million assumed growth coming out of utilization, which is actually a conservative number that comes out of a combination of the compounded monthly increase in utilization across a baseline of some attrition assumption. And then we assume a very modest increase in the fees related to additional professional services orders.

And then of course now your at really our assumption around same-store sales or the growth that we're going to have in 2012 off our existing client base. And you can see that alone gets us quite close to our \$320 million to \$330 million guidance for the year. And then the last piece that we put in of course our entirely discrete new clients and we could have gotten real granule here, but this figure you see on the screen for new clients is an amalgam of course of the services and the implementation phase, the licenses and the utilization fees that will come from new clients during the course of 2012, we think it's a modest assumption. So there we go, that's how we plan, that's our revenue bridge, lots of recurring revenue coming into the year increases on the existing client base and then of course new client acquisition.

Now I think this going to be my last slide here and I'll pass to Murray to talk about some of our operating metrics that we're introducing and also to do a waterfall on cash flow to get you to be able to reconcile between our EBITDA and our cash earnings to free cash flow which I know is



important to many of you. But first let's talk about the long-term view at KIT digital. The reason why we've taken this approach for years of investing so strongly in the consolidation in our marketplace as much as 50% of our growth over time has been by acquisition. Of course we've been growing strongly as I showed before on a previous slide organically as we believe that the brass ring from doing that was going to be extraordinarily valuable.

And that is really a strong market share position in a very -- in a fast-growing sector, in fact in the slide here, we've shown kind of a four or five-year time frame. This is not official guidance by the way, this is kind of indicative give you a sense of the way we see the Company scaling, is really based on pretty modest organic growth based on our past experience. I think we've compounded here in the low 20%, around 22% organic growth. And you see if we do that from here, from 2012 to 2015 we'll be \$600 million plus in revenue, we'll be doing in the vicinity of 35% on the operating income, non-GAAP operating income or EBITDA, adjusted EBITDA basis. And most importantly on a free cash flow basis, we would be doing well in excess of \$100 million of free cash flow, probably closer to \$120 million, \$130 million based on again very reasonable assumption, not huge leaps year to year and we may indeed be able to get more scalability as we grow.

So this gives you a long-term view of why we're so excited around our opportunity in the business and why we're willing to kind of take some spears and arrows now around the consolidation strategy that we've taken and the investments that we've made in the past in the businesses client services team and so forth, and some of the investments that Gavin spoke to that we're making now around additional sales and marketing, research and development and the cost involved in rationalizing client services area to bring more centralized client services within region into lower cost jurisdiction. So I think with that, I'm been given the que to hand it over to Murray. So Murray why don't you talk through some of the new operating metrics that we're going to be talking about going forward.

Murray Arenson - *KIT digital, Inc. - VP- IR, Corporate Development*

Thanks, Kaleil. This quarter which I'm pleased to say is my first quarter managing investor relations for KIT digital we're taking the step of providing some more detailed metrics regarding the state of our business. We believe that by providing these data points, we'll be enabling investors to better understand as well as track our business. You'll note that our customer base continues to grow and we exited 2011 with approximately 2,450 customers.

As we've grown that base, we've also increased the amount of high margin recurring revenue that we're generating from each customer. On average, our monthly recurring revenue per customer, or MRR, has more than doubled during the course of the year. During the fourth quarter our average MRR per customer was approximately \$6,600. We see this as evidence of the growth within our recurring high-margin software business particularly among large customers. Of course it also speaks to the visibility that we have into future operating periods, as Kaleil highlighted when reviewing our revenue bridge.

With respect to our pipeline of business, we're now reporting the growth that we're seeing quarterly which we base on the probability weighted assessment of our total pipeline. During the fourth quarter, the pipeline grew approximately 4%. And over the course of the past year it grew over 13%. We also continued to see negligible churn on the order of approximately 1% per year from our customers.

Finally DSOs for the quarter were 86 days adjusted for acquisitions. That total is down from 97 days last quarter. Going forward, we continue to work toward lowering that number primarily through renegotiation of terms with certain customers. Overall, we believe DSO levels of less than 70 days are achievable over time though we would expect some fluctuations from quarter to quarter. We should note that we have not had any meaningful issue with respect to collections. Our customer base is composed of large reputable companies and our biggest challenge on this front is the length of time that some of these entities take to pay their invoices within their standard business practices.

Now I'd like to take a closer look at our financial performance and outlook, particularly with respect to the way the cash flows through our P&L and ultimately enables us to generate free cash flow and grow our cash balance. Robin already highlighted the results from the fourth quarter, and there's additional detail in our press release. That said, this slide allows you to see how the revenue dollars flowed through our model and allowed us to generate positive cash flow from operations for the quarter. We were slightly negative on the free cash flow front for the quarter, but as we previously noted, we turned the corner and began generating free cash flow later in the quarter with more than \$2.5 million of free cash flow in the month of December.



Turning to our 2012 guidance, we're reaffirming our expectation for \$320 million to \$330 million in revenue, representing an organic growth rate for the year of more than 30%. That's based on pro forma 2011 revenues of approximately \$246 million. We expect our non-GAAP operating income margin to average 23.5% to 25.5% over the course of the year as we make incremental investments in the business this year. By the end of the year, after the bulk of those investments have been made, we expect our non-GAAP operating income margin to be between 27% and 29%. I also want to note here that we've adopted the terminology a non-GAAP operating income which is common among many software and other leading technology companies. That said, our metric is calculated the same way as our previous metric of operating EBITDA.

We're also forecasting cash-based adjusted EPS of \$1.35 to \$1.45 per share for the full year of 2012. Finally, in tracking our cash generation capabilities down to our free cash flow projection for the year, we're now issuing free cash flow guidance of \$25 million to \$35 million for the year. Again we would point out that this free cash flow generation is expected after accounting for the incremental \$16 million that we'll be investing in our business this year to support the growth that we're seeing particularly among tier 1 and tier 2 customers. Finally, this guidance assumes working capital consumption on the order of approximately 5% of revenues. And we believe there's an opportunity to manage the business nearer to a working capital neutral basis, however as we head into our first expected full year a positive free cash flow, we felt it prudent to assume somewhat higher working capital consumption this year.

Looking now specifically at the first quarter of 2012, we've guided to revenues of at least \$72 million. This would represent a sequential organic increase over fourth quarter, despite the fact that Q4 to Q1 trend is typically flattish. We've also guided the cash-based adjusted EPS of \$0.25 to \$0.30. While we've already discussed our positive and growing free cash flow expectations for the year, we do not expect to generate positive free cash flow in the first quarter.

First as we've noted, we'll be making additional investments in our business that will be heavier in the first part of the year. Second, there are some specific uses of cash that will be required this quarter to support [large] client implementation along the lines of LCs and things like that. But the timing of those uses are such that we expect to see a significant step function up into positive territory in the second quarter, and we expect to see growth in free cash flow from that point forward during the year. Now I'll turn it back over to Kaleil to address some frequently asked questions beginning with a look at our M&A outlook. Kaleil?

Kaleil Isaza Tuzman - *KIT digital, Inc. - Chairman, CEO*

Thanks, Murray. We get a lot of questions around our future M&A activity and strategy. Naturally we've been very active in the past and so there's an expectation of activity in the future. We will continue to assess M&A opportunities but I think where we are now is a much more normalized pace of M&A for a \$300 million software Company where we'll look at discrete buy versus build opportunities on the product road map to come out of our COO and our CTO. They're quite modestly sized companies and sometimes they're kind of early-stage R&D efforts as opposed to the companies we haven't really acted on any opportunity of that sort, but it's not impossible we would in the future.

Secondly, we'll look really at bolstering and probably most importantly resources within region. We have a bulge of opportunities in RFPs globally coming out of the service provider space, telcos and cable companies and broadcasters in places like Asia, Latin America, Middle East and other places where you have these huge greenfield projects that are very exciting and can potentially be some of our biggest business globally but where you need to resources in region, highly skilled in solution delivery, architecting and in project management and in actual delivering, implementation and integration but often don't exist in region it's difficult for us to hire up quickly enough. We do work with some firms within region places like Brazil, Thailand and elsewhere that help support as kind of offshore clusters what we are doing and on occasion we do look at M&A opportunities in that area.

I think the deal that we did at the end of -- on December 30 the last day of 2011, the Sezmi deal gave us some resourcing also great IP where we have a small transaction in Asia that would also-- that would help a burst in business opportunity there from a staffing perspective and also can help swap out other costs that we otherwise would have expanded through hiring people in the field and do so very accretably with revenues that are brought. The bias there towards companies that we worked with before and that I think understand our standard operating procedures and our software.

So and then lastly, the commercial ability and presence of those companies can bring within region. Again you're talking about small companies not talking about anything transformative and I think the right way to think about our M&A strategy going forward is again normal to a Company of our size. Whereas in the past we may be doing 30%, 40% even 50% of our asset base in a year in acquisitions and I think for a Company in our developmental stage something on the order of 5%, 10%, 15% something in that range would probably be seen as much more normal and that's where we are in our business development cycle.

And our means of funding consideration on the M&A front will be also I think different than in the past more focused on where possible using operating cash flow and also debt potentially. There's been a rumor out there since our preliminary release a few weeks ago that we were doing a secondary equity offering, which we're not. So-- but we do explore as we get into a much more cash flow generative phase of our existence over the next year or two, using debt more effectively in our business and I think you heard Murray referring to that as well with reference to LCs and working capital requirement.

So with that, I think we're going to the question-and-answer period. And as I understand it we're going to start with some what we see as frequently asked questions, some questions that have already come through, through our online system. So thank you very much for being a part of this-- the more formal part of our presentation and let's get going.

Murray Arenson - *KIT digital, Inc. - VP- IR, Corporate Development*

Okay, Operator, we're ready to go ahead with the question-and-answer portion of today's broadcast. We're going to start with some questions that have been submitted to us and then we will open up the line to questions coming from the outside. First question that came in is in the last preliminary guidance release we mentioned a strategic committee had been formed to evaluate investment and Company sale options. The question is what is the status of that committee and why wasn't it mentioned in this morning's release?

Kaleil Isaza Tuzman - *KIT digital, Inc. - Chairman, CEO*

Sure, this is Kaleil speaking. In December of 2010 -- excuse me 2011, so about four months ago, we received an unsolicited offer with respect to the Company. And given the nature of the offer and the nature of the bidding party, it necessitated the creation of an independent special transaction committee that we disclosed in a recent press release. The tenor of both the Management and Board opinion here is that this is a very suboptimal time for the Company to be sold given that we think we're dramatically undervalued and very significantly misunderstood as a Company and we think that that will change over the course of the next few quarters as I think our story becomes clearer from an organic growth perspective and there is greater visibility into some of the metrics that govern our business.

That being said, the way these things work is that there has to be a proper response to the inbound interest and there has to be a -- the right analysis done and the right checking done to the extent that you've got a situation that generates the need for shareholders to be exposed to an option. So I think obviously choosing words carefully and obviously the disclosure that was put in the last release a necessary at that time. I think that as I just pointed out right at the end of the broadcast, the nature of this disclosure generated some confusion and some questions about whether we were doing an equity offering and I think that had to do with the phraseology. That was not nature of the disclosure. It had to do with the process that I've just outlined and I think that's probably the extent to which we feel comfortable commenting.

Murray Arenson - *KIT digital, Inc. - VP- IR, Corporate Development*

Okay, we're going to go to the next question that was submitted to us which is what exactly caused the 10-K to be delayed? Robin, do you want to address that?

Robin Smyth - *KIT digital, Inc. - CFO*

Yes, sure, thanks, Murray. We said in the release that auditors need a bit more time to go through the complex intangibles valuation which we-- comes with any acquisition with software of valuing the software customer [with the schedule] and that's nothing unusual. They were-- obviously there were quite a number of acquisitions per year and we also noted that we-- to make sure we got the disclosure right on the strategic transaction committee which Kaleil referred to. So we're working through those and that will be released as we -- in the time frame which we've said.

Murray Arenson - *KIT digital, Inc. - VP- IR, Corporate Development*

Thanks, Robin. We'll take one more that's been submitted here which asks that we've made reference to an acquisition that may be forthcoming. Can we describe this opportunity in more detail, size, et cetera, those sorts of characteristics? Kaleil?

Kaleil Isaza Tuzman - *KIT digital, Inc. - Chairman, CEO*

Sure, Murray. The-- it's Kaleil speaking, we've actually referred to a couple of small opportunities in Asia and Latin America respectively for a few quarters now. We're very circumspect at this point in terms of new acquisition activity and so we've wanted to kind of track working with those small companies in the field servicing clients. But it's function is good overflow capacity for us on the services side and have really good experience in OTT deployments in their respective markets. These are not -- neither of these would be qualified as a material transaction. I think one is-- we're hopeful is quite close to completion which would support what we're seeing as really a burgeoning pipeline in Asia as we've said in several press releases particularly Southeast Asia, Austral/Asia and parts of Northeast Asia.

We don't anticipate really engaging an acquisition activity with reference to markets like China and India where we've chosen to pursue an organic hiring path for a variety reasons. But we want to be forthright about the fact the Company continues to assess opportunities, but as we've said they're quite modest in size and these are the same opportunities we refer to in fact over the course of several quarters.

Murray Arenson - *KIT digital, Inc. - VP- IR, Corporate Development*

Thanks, Kaleil Operator, I think we're going to go ahead and open it up to questions from callers who are on the line.

QUESTIONS AND ANSWERS

Murray Arenson - *KIT digital, Inc. - VP- IR, Corporate Development*

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Operator

Thank you. We will now begin the question-and-answer session. (Operator Instructions) Richard Ingrassia from ROTH Capital Partners.

Richard Ingrassia - ROTH Capital Partners - Analyst

Thanks, good morning, everybody. Two of my questions were answered from the web here, but I had a third. Can you reconcile from the implied EBITDA or non-GAAP operating income guidance of what comes to about \$80 million at the midpoints and the \$25 million to \$35 million in free cash flow guidance now for the year?

Murray Arenson - KIT digital, Inc. - VP- IR, Corporate Development

Hello, Rich, it's Murray. There's in between -- well I should say a couple of things. First of all, the non-GAAP operating income, as we stated before, is really the same calculation that we've been dealing with with respect to EBITDA. We tried with some of the slides today to kind of walk you through the way the cash flows flow beyond that level. So in between that and our cash adjusted EBITDA, we're really talking primarily about adjustments for cash interest and taxes.

Secondarily if there are restructuring integration charges, those will come into play as the difference between those two items, but that obviously wasn't the case in this quarter. And then from there on in between the cash-based EPS number and the free cash flow number, the only real differences there are capital expenditures, which we've guided to in the neighborhood of about 4% a year, and working capital, which I discussed in our prepared remarks, as well.

Kaleil Isaza Tuzman - KIT digital, Inc. - Chairman, CEO

Yes, Rich, it's Kaleil. Just to emphasize two points that Murray made in the broadcast and just now. One, that flow or waterfall would be after the investments that we describe in the press release a few weeks ago, which I think we put it around \$16 million in total, which we think will position ourselves well for growth going into 2013 and beyond. And it also is after a relatively conservative, meaning relatively large, assumed working capital assumption relative to what I think we can achieve.

So as Murray said in the broadcast, we believe that especially with the use of maybe a revolver facility, which, as you know, we don't have, and as we get a little bit bigger and can handle these contracts are getting larger, handle some of these performance bond requests and so forth without using our own cash, I think that will help, as well, on the working capital side. It's a pretty significant swing, but I think Murray we're assuming something on the order of about 5% of revenue and kind of working capital assumption, so you can do the math, and obviously, if we're able to move that number down, that would move the FCF number up.

Richard Ingrassia - ROTH Capital Partners - Analyst

Okay. All right, thank you.

Operator

Richard Fetyko with Janney Capital.

Richard Fetyko - Janney Capital Markets - Analyst

Hello, good morning, guys. Couple questions, in Latin America you mentioned a couple weeks ago when you adjusted the guidance that you make some investments in there. Just curious, I believe that you supported that region with a couple of partners in the area and the Miami office.

What changes you are making in that sales approach? And then secondly, with respect to the two targets or potential acquisitions that you had just mentioned, I was just curious what size are those acquisitions, what should we anticipate in terms how much you're willing to spend, or what kind of revenue run rate these companies may have?

Kaleil Isaza Tuzman - KIT digital, Inc. - Chairman, CEO

Sure. Well Latin America is an area of significant growth for us. It's one of the couple of areas where we probably have the highest marginal growth in the world. Not necessarily the highest absolute revenue numbers, obviously, based on our story very strong presence in the more mature markets. But we're seeing a race to basically front run Netflix that's made announcements that they're going to be active in the area.

And so, from Mexico to Brazil to Argentina and elsewhere in the region, you're seeing very quick reactions by sophisticated and large service providers and media companies. And so far, we're batting a very good average in adding those clients, some of which had been referred to in this and past releases, and some of which are still under in deployment and have not been formally announced.

So, the leadership based out of Miami and Buenos Aires is doing a great job in Latin America and we don't anticipate any changes in that leadership. In terms of the acquisition, particularly in Brazil that we've referred to now for some time, it's quite a small company, well less than \$10 million of revenue. But we think it positions us in a very attractive market for the future at a very good price.

And that it will function potentially as a client service center at attractive labor rates for our activity in North America as well. That being said, I think all acquisitions are complex, and particularly when it comes to jurisdiction like Brazil. So it may be that it doesn't come to fruition, but this is something we referred to before, it's not a new target.

Richard Fetyko - Janney Capital Markets - Analyst

Thank you.

Kaleil Isaza Tuzman - KIT digital, Inc. - Chairman, CEO

You're welcome.

Operator

Darren Aftahi from Northland Securities.

Darren Aftahi - Northland Securities - Analyst

Hi, guys, thanks for taking my question. I just have a few. First one I guess, kind of the step up in revenue in the first quarter which is seasonally traditionally down, how much of that step up is from implementation fees, would be my first question? And then second, could you give some clarity in terms of where you kind of see operating margins in the first quarter? And then I've got a couple of follow ups.

Kaleil Isaza Tuzman - *KIT digital, Inc. - Chairman, CEO*

Sure. I think that it's a safe assumption to think about Q1 as a similar type of profile with respect to margins as Q4, which is a positive given the -- what we often see in the cycle for Q1. So I think that's probably as specific as we'd be at this time. I don't know if you want to add anything, Murray?

Murray Arenson - *KIT digital, Inc. - VP- IR, Corporate Development*

Yes I mean we have talked-- we have talked obviously about the spending we'll be making during the course of year, so some of that, or I should say a large percentage of that ends up happening in the first part of the year. I think having walked through the flow of funds, if you will, the cash flow waterfall, that you can kind of see the moving pieces in between the cash adjusted EBITDA, or the cash adjusted EPS, I should say, and the non-GAAP operating income, so that there's not a lot of moving pieces in between there.

Darren Aftahi - *Northland Securities - Analyst*

And then what was actual free cash flow in the fourth quarter for 2011? And then you referred to getting to DSOs sub 70, just using 70 as a number, what's the time frame to get there? And how do you get there, if you continue to make acquisitions and kind of impede that, I mean I guess, when you get sort of a normalized 70, 75 days that's achievable?

Murray Arenson - *KIT digital, Inc. - VP- IR, Corporate Development*

Okay this is Murray. Let me-- first on the free cash flow question. I would say that we were close to a neutral sort of number in terms of free cash flow a little bit negative. So, we were pleased that we came out with a positive cash flow from operations, less the capital expenditures put us slightly of the negative side of things for the quarter overall.

In terms of DSOs, there was nothing particular to point to in this quarter. We've got ongoing efforts to renegotiate some of the terms that we have with existing clients. We feel like we can work those down over time. We expect some fluctuations if things move forward. There wasn't anything in particular in this quarter to point to the shift of things in any material sort of fashion.

Darren Aftahi - *Northland Securities - Analyst*

Great, thank you.

Kaleil Isaza Tuzman - *KIT digital, Inc. - Chairman, CEO*

I think there--

Murray Arenson - *KIT digital, Inc. - VP- IR, Corporate Development*

Yes, if I can we did have a couple questions come in over the web, as well that I think are questions that we do get from time to time, so it probably makes sense to address them here. The first is, can we review the amount of potential earn outs and the anticipated schedule for awarding those earn outs from previous acquisitions?

Robin Smyth - *KIT digital, Inc. - CFO*

Murray, thanks for the question, it's Robin. There's a bit of a misconception that we have a large earn out hangover in the Company. That's not really the case. We estimate that we will probably issue about 2.5 to 3.5 million shares in earn outs over the probably the next three years.

Murray Arenson - *KIT digital, Inc. - VP- IR, Corporate Development*

And the second question on a similar sort of front, is are there any pending lock up provisions that are set to expire in the coming months?

Robin Smyth - *KIT digital, Inc. - CFO*

No, again I don't think there's-- there isn't anything of any relevance there. There's probably about 1 million shares that come out of escrow for acquisitions that -- from the early part of 2011 acquisitions.

Murray Arenson - *KIT digital, Inc. - VP- IR, Corporate Development*

Thanks, Robin. Operator, let's take a couple of additional questions if we can from the lines.

Operator

Jeff Rath with Canaccord Genuity.

Jeff Rath - *Canaccord Genuity - Analyst*

Hi, guys. Just I wondered if you could expand on a couple points that you made in your script, and then in the call so far. So you've talked about the \$16 million of additional investments, can you speak specifically as to what's going on there?

Where are you making those investments? And as you think about those being front end-loaded, why do those investments go away in the back half? So any color you can give us on how to think about that incremental investment and if it drives additional revenue or if it's just essentially an upfront cost.

And then I had sort of a similar question with regards to your rationalization commentary. In your script you talk about \$10 million of expected rationalization or savings, so can you help us understand what's driving that? Are those -- is that just continued centralization of operations, underperforming assets, and will those result in cash charges or intangible charges throughout the year? Thanks and I have one follow up.

Kaleil Isaza Tuzman - *KIT digital, Inc. - Chairman, CEO*

Sure, Jeff, it's Kaleil. In our release we put out a few weeks ago, we actually went through those investments and rationalization exercises in quite a bit of detail, or I should say, some degree of detail. We broke it out into a few different categories and gave the numbers for each of those categories in sales and marketing, in R&D and also talked to, on your last point, some of the effects of the rationalization. And to be specific, we said about \$5 million of additional investment going to sales and marketing including solution design and channel sales programs, which is very important if you look at IBM, Accenture, Harmonic and other important partnerships that have come through for this Company over last six months, that we really couldn't have dreamed of putting together a year or two ago and we think set us up for growth in the out years. It's quite important to invest in that.

We also said we'd have about \$3 million of additional investment in R&D, which is important for us particularly around kind of prefabricating adapters into other systems of record, namely systems around customer identity authentication and billing, as well as general other firmware systems where we have to-- where their OTT extensions off of existing traditional MSO infrastructure, like in a conditional access and storage and other forms of access area.



We have about \$4.5 million of that total that goes to performance management initiatives really this is not additional bonuses or incentives. It actually has to do with severance costs and transition costs related to the replacement of poor performers, as well as rationalization around certain service centers to better support our forward growth. And also some recruitment of additional engineering personnel and client services personnel in Asia/Pac and Latin America, which as we said earlier on the call, may be replaced in certain cases by a small acquisition in one or two of those regions. So we're flexible, whatever's the best economic solution.

And then lastly, would have about \$3.5 million in office consolidation costs and relocation, of specifically in the facility side of certain client service and data centers to lower cost jurisdictions. So that's outlined in the press release that we put out on the 27th of February, and tried to put that out in a good degree of detail.

We know that as a public Company that lives on a quarterly cycle, it isn't popular to refer to investments of this type when it affects near-term performance. But we absolutely think it's the right thing to do, and we think the tangible ROI will be visible in a short period of time, measured in a matter of months and quarters not years. And so that's the nature of the investments. And I think on your last point, the savings that we think we'll realize in of around \$10 million or more in 2013 is really a function of the client service center rationalization and consolidation effort. So--

Jeff Rath - *Canaccord Genuity - Analyst*

Great, just the follow ups, if I can. With regards to your delayed 10-K, can we expect that possibly there could be any intangible write-downs? And how confident are you it's-- we're not going to get surprised by anything that comes out of the filing, given that the books aren't closed yet? So, any comfort and commentary and then I had one last follow up.

Robin Smyth - *KIT digital, Inc. - CFO*

Robin here. Yes, I wouldn't expect any write-downs at this stage at all. We're feeling confident in what we're presenting today. And obviously we haven't filed the 10-K. Until it's done, it's obviously open. But we're-- I think we're comfortable with the numbers we're talking about now, or I don't think we would be doing it.

Jeff Rath - *Canaccord Genuity - Analyst*

Okay. And the final one is just for Kaleil. This morning, Kaleil, Cisco has announced its intentions to acquire NDS Corporation. I wondered for the sake of your view of the emerging competitive landscape, how do you see that both at a macro, and then a competitive dynamic as it relates to KIT? Thanks.

Kaleil Isaza Tuzman - *KIT digital, Inc. - Chairman, CEO*

Sure, I was wondering if someone was going to ask about the big news this morning. I'm going to be certainly be listening in on the call in whatever it is, an hour or so. As we've said as recently as investor conference earlier this week, NDS, at least in terms of their language, had become kind of probably one of our most frontal competitors, and at the same time we've integrated with them and partnered with them on several key clients, including BskyB and Liberty Global and others.

And their CEO is someone we have quite a bit of respect for, their new CEO, Dave Habiger, and have met a number of folks on the team, and have really explored ways we could collaborate as well, because obviously it's a company in transition from a set top box and essentially authored middleware and firmware company to a company that's trying to do things that are more akin to what KIT digital does.

So I think that the conditional access industry is obviously in a lot of flux, and I think it'll be interesting to see whether Cisco is trying to capitalize on the existing conditional access infrastructure in order to sell through more Cisco product or whether there's really going to be an ongoing push



like NDS at least was articulating that they were going to do when they were kind of preparing for their IPO, to move into the video content management space.

We've been saying for a long time, and obviously from a market perspective it seems to either fall on deaf ears or very doubtful ears, but we've been saying for a long time that the firmware infrastructure in video management, which are so many companies in this area from the conditional access guys like NDS and Irdeto and Nagravision, to the folks that some of them are partnered with like Harmonic and others like Ares and Vizrt, and so forth.

There's so many firmware companies out there serving the ecology that we really provide through a platform as a service abstracted infrastructure, much lower cost, OpEx versus CapEx approach. And we think all that firmware over the next 5, 10 years is going to really move to the cloud and move to software. And so this I think is a confirmation of the value companies that are positioned to do that. And I think, in my humble opinion I think you'll see more of that.

So I think it's great for the sector, I think it'll raise awareness. I'm not sure, like I said, exactly where Cisco will take it strategically. Videoscape has been a very interesting idea to watch for years, but I'm not sure it has fructified like people thought, and kind of taken time to shake out. But from our perspective, if you'll permit us a little bit of a competitive gumption, anything that kind of distracts or moves around a company that obviously had it's sights or has it's sights on elements of what we're doing is probably a good thing. And I think it certainly speaks to our strategic value.

Jeff Rath - *Canaccord Genuity - Analyst*

Thank you.

Murray Arenson - *KIT digital, Inc. - VP- IR, Corporate Development*

All right, Operator, I think we have time for one more question, please.

Operator

And at this time there are no further questions in the queue.

Kaleil Isaza Tuzman - *KIT digital, Inc. - Chairman, CEO*

Okay. Well thank you very much for joining the call and as always we're available by e-mail, I'm on kaleil@kitd.com, and rather than go through the other e-mail addresses come visit our website, look at the Management team where we have all the addresses up there and we'll talk to you soon. Thank you.

Operator

Thank you. Before we conclude today's call, I would like to take a moment to read the Company's Safe Harbor Statement. Today's presentation contains certain forward-looking statements related to the businesses of KIT digital which can be identified by the use of forward-looking terminology such as believe, estimate, expect, intend, anticipates, will continue, projects, plans and variations of such words or similar expressions. Statements in today's presentation that were forward-looking included, but were not limited to, statements made by the Management regarding estimated levels of revenues, non-GAAP operating margin, cash-based adjusted EPS, estimated capital expenditures as a percentage of revenues, anticipated organic annual growth rate, potential strategic transactions and future stock listing on the LSE.

Such forward-looking statements involve known and unknown risks and uncertainties including uncertainties relating to the product development and commercialization, integration of acquired businesses, the ability to obtain or maintain patent or other proprietary intellectual property



protection, marketing acceptance, future capital requirements, regulatory actions or delays, competition in general and other factors that may cause actual results to be materially different from those described herein. Certain risks. Certain of these risks and uncertainties are or will be described in the greater detail in our public filings with the US Securities and Exchange Commission. As are required by the US Federal Securities laws, KIT digital is not under any obligation to and expressly disclaims any such obligation to update or alter it's forward-looking statements whether as a result of new information, future events or otherwise.

I would like to remind everyone the video webcast of this presentation will be available for replay via the Company's investor relations section at www.kitd.com. starting at 1.30 PM Eastern Time later today. This concludes today's call. Thank you, ladies and gentlemen, for joining us for today's presentation. You may now disconnect.

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