

PEGASYSTEMS INC  
Form 10-Q  
October 27, 2015  
Table of Contents

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**Washington, D.C. 20549**

**FORM 10-Q**

(Mark One)

**Quarterly Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the quarterly period ended September 30, 2015**

or

**Transition Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_**

**Commission File Number: 1-11859**

**PEGASYSTEMS INC.**

**(Exact name of Registrant as specified in its charter)**

<b>Massachusetts</b> <b>(State or other jurisdiction of</b>	<b>04-2787865</b> <b>(IRS Employer</b>
<b>incorporation or organization)</b>	<b>Identification No.)</b>
<b>One Rogers Street Cambridge, MA</b> <b>(Address of principal executive offices)</b>	<b>02142-1209</b> <b>(Zip Code)</b>
<b>(617) 374-9600</b> <b>(Registrant's telephone number including area code)</b>	

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer", "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer <input checked="" type="checkbox"/>	Accelerated filer <input type="checkbox"/>
Non-accelerated filer <input type="checkbox"/> (Do not check if smaller reporting company)	Smaller reporting company <input type="checkbox"/>

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

There were 76,421,098 shares of the Registrant's common stock, \$.01 par value per share, outstanding on October 16, 2015.

**Table of Contents**

**PEGASYSTEMS INC.**

**Index to Form 10-Q**

		<b>Page</b>
<b><u>Part I Financial Information</u></b>		
Item 1.	<u>Financial Statements (Unaudited):</u>	
	<u>Condensed Consolidated Balance Sheets as of September 30, 2015 and December 31, 2014</u>	3
	<u>Condensed Consolidated Statements of Operations for the three and nine months ended September 30, 2015 and 2014</u>	4
	<u>Condensed Consolidated Statements of Comprehensive Income (Loss) for the three and nine months ended September 30, 2015 and 2014</u>	5
	<u>Condensed Consolidated Statements of Cash Flows for the nine months ended September 30, 2015 and 2014</u>	6
	<u>Notes to Condensed Consolidated Financial Statements</u>	7
Item 2.	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	16
Item 3.	<u>Quantitative and Qualitative Disclosures About Market Risk</u>	25
Item 4.	<u>Controls and Procedures</u>	26
<b><u>Part II Other Information</u></b>		
Item 1A.	<u>Risk Factors</u>	26
Item 2.	<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	26
Item 6.	<u>Exhibits</u>	27
	<u>SIGNATURE</u>	28

Table of Contents

## PEGASYSTEMS INC.

## UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands)

	As of September 30, 2015	As of December 31, 2014
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 97,278	\$ 114,585
Marketable securities	126,738	96,631
Total cash, cash equivalents, and marketable securities	224,016	211,216
Trade accounts receivable, net of allowance of \$2,100 and \$1,540	129,252	154,844
Deferred income taxes	12,903	12,974
Income taxes receivable	14,688	4,502
Other current assets	12,310	9,544
Total current assets	393,169	393,080
Property and equipment, net	31,830	30,156
Long-term deferred income taxes	71,998	69,258
Long-term other assets	3,715	2,783
Intangible assets, net	36,412	45,664
Goodwill	46,816	46,860
Total assets	\$ 583,940	\$ 587,801
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 7,617	\$ 4,752
Accrued expenses	39,049	42,958
Accrued compensation and related expenses	43,386	47,250
Deferred revenue	134,075	134,672
Total current liabilities	224,127	229,632
Income taxes payable	24,562	24,896

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Long-term deferred revenue	13,857	20,859
Other long-term liabilities	16,348	17,709
<b>Total liabilities</b>	<b>278,894</b>	<b>293,096</b>
Stockholders' equity:		
Preferred stock, 1,000 shares authorized; no shares issued and outstanding		
Common stock, 200,000 shares authorized; 76,465 shares and 76,357 shares issued and outstanding	765	764
Additional paid-in capital	145,466	141,495
Retained earnings	161,522	153,058
Accumulated other comprehensive loss	(2,707)	(612)
<b>Total stockholders' equity</b>	<b>305,046</b>	<b>294,705</b>
<b>Total liabilities and stockholders' equity</b>	<b>\$ 583,940</b>	<b>\$ 587,801</b>

See notes to unaudited condensed consolidated financial statements.

**Table of Contents****PEGASYSTEMS INC.****UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS****(in thousands, except per share amounts)**

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2015</b>	<b>2014</b>	<b>2015</b>	<b>2014</b>
<b>Revenue:</b>				
Software license	\$ 58,948	\$ 48,292	\$ 180,420	\$ 154,918
Maintenance	52,285	47,281	150,366	137,555
Services	51,170	42,058	147,554	128,607
<b>Total revenue</b>	<b>162,403</b>	<b>137,631</b>	<b>478,340</b>	<b>421,080</b>
<b>Cost of revenue:</b>				
Software license	1,000	1,076	3,106	3,832
Maintenance	5,644	5,385	16,300	15,093
Services	48,797	39,921	140,875	120,061
<b>Total cost of revenue</b>	<b>55,441</b>	<b>46,382</b>	<b>160,281</b>	<b>138,986</b>
<b>Gross profit</b>	<b>106,962</b>	<b>91,249</b>	<b>318,059</b>	<b>282,094</b>
<b>Operating expenses:</b>				
Selling and marketing	53,640	48,623	169,764	150,772
Research and development	33,032	28,558	94,248	80,490
General and administrative	9,579	8,825	26,138	28,377
Acquisition-related		54	39	417
Restructuring		192		192
<b>Total operating expenses</b>	<b>96,251</b>	<b>86,252</b>	<b>290,189</b>	<b>260,248</b>
<b>Income from operations</b>	<b>10,711</b>	<b>4,997</b>	<b>27,870</b>	<b>21,846</b>
Foreign currency transaction loss	(412)	(2,845)	(4,342)	(2,527)
Interest income, net	278	181	807	468
Other (expense) income, net	(331)	19	(328)	(507)

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Income before provision for income taxes	10,246	2,352	24,007	19,280
Provision for income taxes	3,921	470	8,643	6,129
Net income	\$ 6,325	\$ 1,882	\$ 15,364	\$ 13,151
Earnings per share:				
Basic	\$ 0.08	\$ 0.02	\$ 0.20	\$ 0.17
Diluted	\$ 0.08	\$ 0.02	\$ 0.19	\$ 0.17
Weighted-average number of common shares outstanding:				
Basic	76,534	76,351	76,521	76,312
Diluted	79,174	78,653	78,906	78,531
Cash dividends declared per share	\$ 0.03	\$ 0.03	\$ 0.09	\$ 0.075

See notes to unaudited condensed consolidated financial statements.

**Table of Contents****PEGASYSTEMS INC.****UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)****(in thousands)**

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2015</b>	<b>2014</b>	<b>2015</b>	<b>2014</b>
Net income	\$ 6,325	\$ 1,882	\$ 15,364	\$ 13,151
Other comprehensive loss, net:				
Unrealized gain (loss) on securities, net of tax	162	(90)	167	(62)
Foreign currency translation adjustments	(928)	(3,046)	(2,262)	(1,770)
Total other comprehensive loss, net	(766)	(3,136)	(2,095)	(1,832)
Comprehensive income (loss)	\$ 5,559	\$ (1,254)	\$ 13,269	\$ 11,319

See notes to unaudited condensed consolidated financial statements.



**Table of Contents****PEGASYSTEMS INC.****UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(in thousands)**

	<b>Nine Months Ended September 30,</b>	
	<b>2015</b>	<b>2014</b>
<b>Operating activities:</b>		
Net income	\$ 15,364	\$ 13,151
<b>Adjustments to reconcile net income to cash provided by operating activities:</b>		
Excess tax benefits from exercise or vesting of equity awards	(4,661)	(3,754)
Deferred income taxes	(2,889)	(1,845)
Depreciation and amortization	17,570	17,167
Stock-based compensation expense	23,005	13,721
Foreign currency transaction loss	4,342	2,527
Other non-cash items	1,129	939
<b>Change in operating assets and liabilities:</b>		
Trade accounts receivable	21,969	59,049
Income taxes receivable and other current assets	(8,670)	(3,839)
Accounts payable and accrued expenses	(4,108)	(1,448)
Deferred revenue	(6,925)	4,287
Other long-term assets and liabilities	(1,198)	(1,688)
Cash provided by operating activities	54,928	98,267
<b>Investing activities:</b>		
Purchases of marketable securities	(66,946)	(36,232)
Proceeds from maturities and called marketable securities	33,916	22,156
Sale of marketable securities	1,915	
Payments for acquisitions	(1,671)	(2,600)
Investment in property and equipment	(9,950)	(5,809)
Cash used in investing activities	(42,736)	(22,485)
<b>Financing activities:</b>		

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Issuance of common stock for share-based compensation plans	722	629
Excess tax benefits from exercise or vesting of equity awards	4,661	3,754
Dividend payments to shareholders	(6,896)	(4,581)
Common stock repurchases for tax withholdings for net settlement of equity awards	(7,149)	(4,939)
Common stock repurchases under share repurchase programs	(17,000)	(12,266)
Cash used in financing activities	(25,662)	(17,403)
Effect of exchange rates on cash and cash equivalents	(3,837)	(2,065)
Net (decrease) increase in cash and cash equivalents	(17,307)	56,314
Cash and cash equivalents, beginning of period	114,585	80,231
Cash and cash equivalents, end of period	\$ 97,278	\$ 136,545

See notes to unaudited condensed consolidated financial statements.

**Table of Contents**

**PEGASYSTEMS INC.**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**1. ACCOUNTING POLICIES**

***Basis of Presentation***

Pegasystems Inc. (together with its subsidiaries, the Company) has prepared the accompanying unaudited condensed consolidated financial statements pursuant to the rules and regulations of the U.S. Securities and Exchange Commission (SEC) regarding interim financial reporting. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America (U.S.) for complete financial statements and should be read in conjunction with the Company's audited financial statements included in the Annual Report on Form 10-K for the year ended December 31, 2014.

In the opinion of management, the Company has prepared the accompanying unaudited condensed consolidated financial statements on the same basis as its audited financial statements, and these financial statements include all adjustments, consisting only of normal recurring adjustments, necessary for a fair presentation of the results of the interim periods presented. The operating results for the interim periods presented are not necessarily indicative of the results expected for the full year 2015.

**2. NEW ACCOUNTING PRONOUNCEMENTS**

***Revenue from Contracts with Customers:*** In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2014-09, Revenue from Contracts with Customers (Topic 606). This ASU amends the guidance for revenue recognition to replace numerous, industry-specific requirements, and converges areas under this topic with those of the International Financial Reporting Standards. This ASU implements a five-step process for customer contract revenue recognition that focuses on transfer of control, as opposed to transfer of risk and rewards. This ASU also requires enhanced disclosures regarding the nature, amount, timing, and uncertainty of revenues and cash flows from contracts with customers. This ASU originally had an effective date for the Company of January 1, 2017. In August 2015, the FASB issued ASU No. 2015-14, Revenue from Contracts with Customers (Topic 606) Deferral of the Effective Date, which defers the effective date by one year while providing the option to adopt the standard on the original effective date. The new effective date for the Company will be January 1, 2018. Management is currently assessing the impact the adoption of this ASU will have on the Company's consolidated financial statements.

**Table of Contents****3. MARKETABLE SECURITIES**

(in thousands)	September 30, 2015			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
Municipal bonds	\$ 52,207	\$ 110	\$	\$ 52,317
Corporate bonds	71,530	25	(31)	71,524
Certificates of deposit	2,894	3		2,897
	\$ 126,631	\$ 138	\$ (31)	\$ 126,738

(in thousands)	December 31, 2014			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
Municipal bonds	\$ 27,820	\$ 52	\$ (17)	\$ 27,855
Corporate bonds	65,487	5	(144)	65,348
Certificates of deposit	3,428	2	(2)	3,428
	\$ 96,735	\$ 59	\$ (163)	\$ 96,631

The Company considers debt securities with maturities of three months or less from the purchase date to be cash equivalents. Interest is recorded when earned. All of the Company's investments are classified as available-for-sale and are carried at fair value with unrealized gains and losses recorded as a component of accumulated other comprehensive loss, net of related income taxes.

As of September 30, 2015, remaining maturities of marketable debt securities ranged from October 2015 to September 2018, with a weighted-average remaining maturity of approximately 16 months.

**4. DERIVATIVE INSTRUMENTS**

The Company has historically used foreign currency forward contracts (forward contracts) to manage its exposure to changes in foreign currency exchange rates associated with its foreign currency denominated cash, accounts receivable, and intercompany receivables and payables held by its U.S. operating company.

Effective on April 1, 2015, the Company restructured its operations with its clients based outside the Americas. These clients began transacting with Pegasystems Limited, a United Kingdom (U.K.) subsidiary of Pegasystems Inc., which has the British pound as its functional currency. This reorganization resulted in increased cash, accounts receivable, and intercompany receivables and payables held by Pegasystems Limited in currencies other than the British pound. As a result, the Company's exposure to foreign currency exchange rate fluctuations in the U.S. dollar, the Euro, and the Australian dollar relative to the British pound increased, while its exposure to foreign currency exchange rate fluctuations in the British pound, the Euro, and the Australian dollar relative to the U.S. dollar decreased.

In July 2015, as a result of this operational reorganization, the Company implemented its revised hedging program under which it fully or partially hedges its non-functional currency exposures for Pegasystems Inc. and Pegasystems Limited, utilizing forward contracts with terms not greater than six months.

The forward contracts are not designated as hedging instruments. As a result, the Company records the fair value of these contracts at the end of each reporting period in its consolidated balance sheets as other current assets for unrealized gains and accrued expenses for unrealized losses, with any fluctuations in the value of these contracts recognized in other (expense) income, net, in its consolidated statements of operations. The cash flows related to these forward contracts are classified as operating activities in the Company's consolidated statements of cash flows.

As of September 30, 2015, the total notional amount of the Company's outstanding forward contracts was \$55.7 million. The Company did not have any outstanding forward contracts as of December 31, 2014.

**Table of Contents**

The fair value of the Company's outstanding forward contracts as of September 30, 2015 was as follows:

(in thousands)	Asset Derivatives		Liability Derivatives	
	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value
Foreign currency forward contracts	Other current assets	\$ 140	Accrued expenses	\$ 1,035

The Company entered into forward contracts with notional values as follows:

Currency (in thousands)	Notional Amount			
	Three Months Ended September 30,		Nine Months Ended September 30,	
	2015	2014	2015	2014
Euro	33,309		33,309	21,900
British pound	£ 10,300	£	£ 10,300	£ 26,500
Australian dollar	A\$ 27,000	A\$	A\$ 27,000	A\$ 12,900
Indian rupee	Rs 300,000	Rs	Rs 300,000	Rs 204,000
United States dollar	\$ 45,500	\$	\$ 45,500	\$

(in thousands)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2015	2014	2015	2014
Loss from the change in the fair value of forward contracts included in other (expense) income, net	\$ (319)	\$	\$ (319)	\$ (532)
Foreign currency transaction losses from the remeasurement of foreign currency assets and liabilities	\$ (412)	\$ (2,845)	\$ (4,342)	\$ (2,527)

## 5. FAIR VALUE MEASUREMENTS

### Assets and Liabilities Measured at Fair Value on a Recurring Basis

The Company records its marketable securities and forward contracts at fair value on a recurring basis. Fair value is an exit price, representing the amount that would be received from the sale of an asset or paid to transfer a liability in an orderly transaction between market participants based on assumptions that market participants would use in pricing an asset or liability. As a basis for classifying the fair value measurements, a three-tier fair value hierarchy, which classifies the fair value measurements based on the inputs used in measuring fair value, was established as follows: (Level 1) observable inputs such as quoted prices in active markets for identical assets or liabilities; (Level 2) significant other inputs that are observable either directly or indirectly; and (Level 3) significant unobservable inputs

on which there is little or no market data, which require the Company to develop its own assumptions. This hierarchy requires the Company to use observable market data, when available, and to minimize the use of unobservable inputs when determining fair value.

The Company's money market funds are classified within Level 1 of the fair value hierarchy. The Company's investments classified within Level 2 of the fair value hierarchy are valued based on a market approach using quoted prices, when available, or matrix pricing compiled by third party pricing vendors, using observable market inputs such as interest rates, yield curves, and credit risk. The Company's foreign currency forward contracts which are all classified within Level 2 of the fair value hierarchy are valued based on the notional amounts and rates under the contracts and observable market inputs such as currency exchange rates and credit risk. If applicable, the Company will recognize transfers into and out of levels within the fair value hierarchy at the end of the reporting period in which the actual event or change in circumstance occurs. There were no significant transfers between Level 1 and Level 2 during the three and nine months ended September 30, 2015.

**Table of Contents**

The Company's assets and liabilities measured at fair value on a recurring basis consisted of the following:

(in thousands)	Fair Value Measurements at Reporting Date Using		
	September 30, 2015	Level 1	Level 2
<b>Fair Value Assets:</b>			
Money market funds	\$ 479	\$ 479	\$
<b>Marketable securities:</b>			
Municipal bonds	\$ 52,317	\$	\$ 52,317
Corporate bonds	71,524		71,524
Certificates of deposit	2,897		2,897
<b>Total marketable securities</b>	<b>\$ 126,738</b>	<b>\$</b>	<b>\$ 126,738</b>
Foreign currency forward contracts	\$ 140	\$	\$ 140
	\$ 127,357	\$ 479	\$ 126,878
<b>Fair Value Liabilities:</b>			
Foreign currency forward contracts	\$ 1,035	\$	\$ 1,035

(in thousands)	Fair Value Measurements at Reporting Date Using		
	December 31, 2014	Level 1	Level 2
<b>Fair Value Assets:</b>			
Money market funds	\$ 2,295	\$ 2,295	\$
<b>Marketable securities:</b>			
Municipal bonds	\$ 27,855	\$	\$ 27,855
Corporate bonds	65,348		65,348
Certificates of deposit	3,428		3,428
<b>Total marketable securities</b>	<b>\$ 96,631</b>	<b>\$</b>	<b>\$ 96,631</b>
	\$ 98,926	\$ 2,295	\$ 96,631

Assets Measured at Fair Value on a Nonrecurring Basis



Assets recorded at fair value on a nonrecurring basis, such as property and equipment, and intangible assets, are recognized at fair value when they are impaired. During the nine months of 2015 and 2014, the Company did not recognize any impairments on its assets measured at fair value on a nonrecurring basis.

**Table of Contents****6. TRADE ACCOUNTS RECEIVABLE, NET OF ALLOWANCE**

<b>(in thousands)</b>	<b>September 30, December 31,</b>	
	<b>2015</b>	<b>2014</b>
Trade accounts receivable	\$ 113,207	\$ 128,757
Unbilled trade accounts receivable	18,145	27,627
<b>Total accounts receivable</b>	<b>131,352</b>	<b>156,384</b>
Allowance for sales credit memos	(2,100)	(1,540)
	<b>\$ 129,252</b>	<b>\$ 154,844</b>

Unbilled trade accounts receivable primarily relate to services revenue earned under time and materials arrangements and to maintenance and license arrangements that have commenced or been delivered but have not been invoiced.

**7. GOODWILL AND OTHER INTANGIBLE ASSETS**

Changes in the carrying amount of goodwill:

<b>(in thousands)</b>	<b>2015</b>
Balance as of January 1,	\$ 46,860
Translation adjustments	(44)
<b>Balance as of September 30,</b>	<b>\$ 46,816</b>

Intangible assets are recorded at cost and are amortized using the straight-line method over their estimated useful lives.

<b>(in thousands)</b>	<b>Range of Useful Lives</b>	<b>Cost</b>	<b>Accumulated Amortization</b>	<b>Net Book Value</b>
<b>As of September 30, 2015</b>				
Customer related intangibles	4-9 years	\$ 49,567	\$ (28,933)	\$ 20,634
Technology	3-9 years	48,342	(32,931)	15,411
Other intangibles	3 years	5,361	(4,994)	367

Total		\$ 103,270	\$ (66,858)	\$ 36,412
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(in thousands)	Range of Useful Lives	Cost	Accumulated Amortization	Net Book Value
<b>As of December 31, 2014</b>				
Customer related intangibles	4-9 years	\$ 49,590	\$ (24,338)	\$ 25,252
Technology	3-9 years	48,342	(28,890)	19,452
Other intangibles	1-3 years	5,361	(4,401)	960
Total		\$ 103,293	\$ (57,629)	\$ 45,664

Amortization of intangibles was reflected in the Company's unaudited condensed consolidated statements of operations as follows:

(in thousands)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2015	2014	2015	2014
Cost of revenue	\$ 1,351	\$ 1,382	\$ 4,041	\$ 4,666
Selling and marketing	1,537	1,501	4,602	4,496
General and administrative	91	574	593	1,475
Total amortization expense	\$ 2,979	\$ 3,457	\$ 9,236	\$ 10,637

**Table of Contents**

Amortization of intangibles is estimated to be recorded over their remaining useful lives as follows:

<b>(in thousands) as of September 30, 2015</b>	<b>Future estimated amortization expense</b>
Remainder of 2015	\$ 2,972
2016	11,520
2017	9,822
2018	8,822
2019 and thereafter	3,276
	\$ 36,412

**8. ACCRUED EXPENSES**

<b>(in thousands)</b>	<b>September 30, 2015</b>	<b>December 31, 2014</b>
Partner commissions	\$ 3,421	\$ 2,441
Other taxes	9,744	10,970
Employee reimbursable expenses	2,544	1,474
Dividends payable	2,298	2,294
Professional services contractor fees	5,100	2,297
Self-insurance health and dental claims	2,471	2,115
Professional fees	1,936	2,444
Short-term deferred rent	1,581	