

BLACKBAUD INC  
Form 10-Q  
November 04, 2016

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

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2016

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: 000-50600

Blackbaud, Inc.  
(Exact name of registrant as specified in its charter)

Delaware 11-2617163  
(State or other jurisdiction of incorporation or organization) (I.R.S. Employer Identification No.)

2000 Daniel Island Drive  
Charleston, South Carolina 29492  
(Address of principal executive offices, including zip code)  
(843) 216-6200  
(Registrant’s telephone number, including area code)

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 (Section 232.405 of this chapter) 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  Accelerated filer   
Non-accelerated filer  (Do not check if a smaller reporting company) Smaller reporting company

Indicate by check mark whether registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

YES  NO

The number of shares of the registrant’s Common Stock outstanding as of October 24, 2016 was 47,581,812.



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Blackbaud, Inc.

**CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS**

This Quarterly Report on Form 10-Q, including the documents incorporated herein by reference, contains forward-looking statements that anticipate results based on our estimates, assumptions and plans that are subject to uncertainty. These "forward-looking statements" are made subject to the safe-harbor provisions of the Private Securities Litigation Reform Act of 1995, Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Forward-looking statements consist of, among other things, trend analyses, statements regarding future events, future financial performance, our anticipated growth, the effect of general economic and market conditions, our business strategy and our plan to build and grow our business, our operating results, our ability to successfully integrate acquired businesses and technologies, the effect of foreign currency exchange rate and interest rate fluctuations on our financial results, the impact of expensing stock-based compensation, the sufficiency of our capital resources, our ability to meet our ongoing debt and obligations as they become due, and potential litigation involving us, all of which are based on current expectations, estimates, and forecasts, and the beliefs and assumptions of our management. Words such as "believes," "seeks," "expects," "may," "might," "should," "intends," "could," "would," "likely," "will," "targets," "plans," "anticipates," "aims," "projects," "estimates" or any such words and similar expressions are also intended to identify such forward-looking statements. These forward-looking statements are subject to risks, uncertainties and assumptions that are difficult to predict. Accordingly, they should not be viewed as assurances of future performance, and actual results may differ materially and adversely from those expressed in any forward-looking statements.

Important factors that could cause actual results to differ materially from our expectations expressed in forward-looking statements include, but are not limited to, those summarized under "Item 1A. Risk factors" and elsewhere in this report, in our Annual Report on Form 10-K for the year ended December 31, 2015 and in our other SEC filings. Forward-looking statements represent our management's beliefs and assumptions only as of the date of this Quarterly Report on Form 10-Q. We undertake no obligation to update or revise any forward-looking statements, or to update the reasons actual results could differ materially from those anticipated in any forward-looking statement, whether as a result of new information, future events or otherwise.

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## PART I. FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS

Blackbaud, Inc.

Consolidated balance sheets

(Unaudited)

(dollars in thousands)

	September 30, 2016	December 31, 2015
Assets		
Current assets:		
Cash and cash equivalents	\$ 16,462	\$ 15,362
Restricted cash due to customers	138,106	255,038
Accounts receivable, net of allowance of \$4,097 and \$4,943 at September 30, 2016 and December 31, 2015, respectively	86,111	80,046
Prepaid expenses and other current assets	52,145	48,666
Total current assets	292,824	399,112
Property and equipment, net	52,466	52,651
Software development costs, net	32,539	19,551
Goodwill	438,450	436,449
Intangible assets, net	264,405	294,672
Other assets	18,102	20,901
Total assets	\$ 1,098,786	\$ 1,223,336
Liabilities and stockholders' equity		
Current liabilities:		
Trade accounts payable	\$ 19,601	\$ 19,208
Accrued expenses and other current liabilities	44,441	57,461
Due to customers	138,106	255,038
Debt, current portion	4,375	4,375
Deferred revenue, current portion	248,152	230,216
Total current liabilities	454,675	566,298
Debt, net of current portion	370,642	403,712
Deferred tax liability	26,688	27,996
Deferred revenue, net of current portion	6,594	7,119
Other liabilities	7,467	7,623
Total liabilities	866,066	1,012,748
Commitments and contingencies (see Note 10)		
Stockholders' equity:		
Preferred stock; 20,000,000 shares authorized, none outstanding	—	—
Common stock, \$0.001 par value; 180,000,000 shares authorized, 57,657,959 and 56,873,817 shares issued at September 30, 2016 and December 31, 2015, respectively	58	57
Additional paid-in capital	302,837	276,340
Treasury stock, at cost; 10,084,745 and 9,903,071 shares at September 30, 2016 and December 31, 2015, respectively	(210,357)	(199,861)
Accumulated other comprehensive loss	(942)	(825)
Retained earnings	141,124	134,877
Total stockholders' equity	232,720	210,588
Total liabilities and stockholders' equity	\$ 1,098,786	\$ 1,223,336

The accompanying notes are an integral part of these consolidated financial statements.



Blackbaud, Inc.

Consolidated statements of comprehensive income  
(Unaudited)

(dollars in thousands, except per share amounts)	Three months ended		Nine months ended	
	September 30, 2016	September 30, 2015	September 30, 2016	September 30, 2015
Revenue				
Subscriptions	\$ 105,440	\$ 80,901	\$ 306,330	\$ 233,423
Maintenance	36,410	38,209	111,019	115,732
Services	36,610	35,905	104,443	100,878
License fees and other	4,603	3,796	10,718	12,030
Total revenue	183,063	158,811	532,510	462,063
Cost of revenue				
Cost of subscriptions	51,943	39,485	153,772	115,063
Cost of maintenance	5,531	6,708	16,547	21,179
Cost of services	24,102	26,235	73,136	79,121
Cost of license fees and other	1,741	1,745	3,363	4,052
Total cost of revenue	83,317	74,173	246,818	219,415
Gross profit	99,746	84,638	285,692	242,648
Operating expenses				
Sales, marketing and customer success	40,690	31,139	115,707	89,424
Research and development	22,510	20,561	67,973	62,003
General and administrative	22,319	18,446	62,089	53,244
Amortization	687	524	2,147	1,536
Total operating expenses	86,206	70,670	247,916	206,207
Income from operations	13,540	13,968	37,776	36,441
Interest expense	(2,641)	(1,816)	(8,037)	(5,375)
Other (expense) income, net	(15)	192	(185)	(1,369)
Income before provision for income taxes	10,884	12,344	29,554	29,697
Income tax provision	1,950	4,433	5,323	10,459
Net income	\$ 8,934	\$ 7,911	\$ 24,231	\$ 19,238
Earnings per share				
Basic	\$ 0.19	\$ 0.17	\$ 0.53	\$ 0.42
Diluted	\$ 0.19	\$ 0.17	\$ 0.51	\$ 0.41
Common shares and equivalents outstanding				
Basic weighted average shares	46,159,956	45,616,832	46,078,306	45,576,029
Diluted weighted average shares	47,394,106	46,596,714	47,268,469	46,403,196
Dividends per share	\$ 0.12	\$ 0.12	\$ 0.36	\$ 0.36
Other comprehensive income (loss)				
Foreign currency translation adjustment	289	168	261	(354)
Unrealized gain (loss) on derivative instruments, net of tax	409	(262)	(378)	(634)
Total other comprehensive income (loss)	698	(94)	(117)	(988)
Comprehensive income	\$ 9,632	\$ 7,817	\$ 24,114	\$ 18,250

The accompanying notes are an integral part of these consolidated financial statements.

Blackbaud, Inc.

Consolidated statements of cash flows

(Unaudited)

	Nine months ended September 30,	
	2016	2015
(dollars in thousands)		
Cash flows from operating activities		
Net income	\$24,231	\$19,238
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	53,109	41,340
Provision for doubtful accounts and sales returns	3,139	4,573
Stock-based compensation expense	25,005	17,899
Deferred taxes	(225)	(2,274)
Loss on sale of business	—	1,976
Amortization of deferred financing costs and discount	718	660
Other non-cash adjustments	(634)	(159)
Changes in operating assets and liabilities, net of acquisition and disposal of businesses:		
Accounts receivable	(9,288)	(6,378)
Prepaid expenses and other assets	(934)	(324)
Trade accounts payable	267	3,284
Accrued expenses and other liabilities	(12,837)	(6,299)
Restricted cash due to customers	119,291	76,091
Due to customers	(119,291)	(76,091)
Deferred revenue	17,593	15,973
Net cash provided by operating activities	100,144	89,509
Cash flows from investing activities		
Purchase of property and equipment	(15,459)	(14,560)
Capitalized software development costs	(19,078)	(10,868)
Purchase of net assets of acquired companies, net of cash	(3,377)	(520)
Net cash used in sale of business	—	(521)
Net cash used in investing activities	(37,914)	(26,469)
Cash flows from financing activities		
Proceeds from issuance of debt	179,000	83,600
Payments on debt	(212,581)	(122,581)
Debt issuance costs	—	(429)
Employee taxes paid for withheld shares upon equity award settlement	(10,497)	(2,728)
Proceeds from exercise of stock options	10	23
Dividend payments to stockholders	(17,108)	(16,883)
Net cash used in financing activities	(61,176)	(58,998)
Effect of exchange rate on cash and cash equivalents	46	(1,222)
Net increase in cash and cash equivalents	1,100	2,820
Cash and cash equivalents, beginning of period	15,362	14,735
Cash and cash equivalents, end of period	\$16,462	\$17,555

The accompanying notes are an integral part of these consolidated financial statements.

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Blackbaud, Inc.

Consolidated statements of stockholders' equity

(Unaudited)

(dollars in thousands)	Common stock		Additional paid-in capital	Treasury stock	Accumulated other comprehensive loss	Retained earnings	Total stockholders' equity
	Shares	Amount					
Balance at December 31, 2014	56,048,135	\$ 56	\$ 245,674	\$(190,440)	\$ (1,032)	\$ 131,658	\$ 185,916
Net income	—	—	—	—	—	25,649	25,649
Payment of dividends	—	—	—	—	—	(22,508)	(22,508)
Exercise of stock options and stock appreciation rights and vesting of restricted stock units	202,078	—	32	—	—	—	32
Surrender of 163,017 shares upon vesting of restricted stock and restricted stock units and exercise of stock appreciation rights	—	—	—	(9,421)	—	—	(9,421)
Excess tax benefits from exercise and vesting of stock-based compensation	—	—	5,466	—	—	—	5,466
Stock-based compensation	—	—	25,168	—	—	78	25,246
Restricted stock grants	736,252	1	—	—	—	—	1
Restricted stock cancellations	(112,648)	—	—	—	—	—	—
Other comprehensive income	—	—	—	—	207	—	207
Balance at December 31, 2015	56,873,817	\$ 57	\$ 276,340	\$(199,861)	\$ (825)	\$ 134,877	\$ 210,588
Cumulative effect of a change in accounting principle <sup>(1)</sup>	—	—	1,540	—	—	(934)	606
Net income	—	—	—	—	—	24,231	24,231
Payment of dividends	—	—	—	—	—	(17,108)	(17,108)
Exercise of stock options and stock appreciation rights and vesting of restricted stock units	298,750	—	10	—	—	—	10
Surrender of 181,674 shares upon vesting of restricted stock and restricted stock units and exercise of stock appreciation rights	—	—	—	(10,496)	—	—	(10,496)
Stock-based compensation	—	—	24,947	—	—	58	25,005
Restricted stock grants	560,298	1	—	—	—	—	1
Restricted stock cancellations	(74,906)	—	—	—	—	—	—
Other comprehensive loss	—	—	—	—	(117)	—	(117)
Balance at September 30, 2016	57,657,959	\$ 58	\$ 302,837	\$(210,357)	\$ (942)	\$ 141,124	\$ 232,720

(1) Includes the impact of early adopting ASU 2016-09, Compensation - Stock Compensation (Topic 718), Improvements to Employee Share-Based Payment Accounting. Refer to the discussion of recently adopted accounting pronouncements in Note 2 to these consolidated financial statements for additional details.

The accompanying notes are an integral part of these consolidated financial statements.

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Blackbaud, Inc.

Notes to consolidated financial statements  
(Unaudited)

1. Organization

We are the world's leading cloud software company powering social good. Serving the entire social good community—nonprofits, foundations, corporations, education institutions, and individual change agents—we connect and empower organizations to increase their impact through software, services, expertise, and data intelligence. Our portfolio is tailored to the unique needs of vertical markets, with solutions for fundraising and relationship management, digital marketing, advocacy, accounting, payments, analytics, school management, grant management, corporate social responsibility and volunteerism. Serving the industry for more than three decades, we are headquartered in Charleston, South Carolina and have operations in the United States, Australia, Canada, Ireland and the United Kingdom. As of September 30, 2016, we had approximately 35,000 customers.

2. Summary of Significant Accounting Policies

Unaudited interim consolidated financial statements

The accompanying interim consolidated financial statements have been prepared pursuant to the rules and regulations of the United States Securities and Exchange Commission ("SEC") for interim financial reporting. These consolidated statements are unaudited and, in the opinion of management, include all adjustments (consisting of normal recurring adjustments and accruals) necessary to state fairly the consolidated balance sheets, consolidated statements of comprehensive income, consolidated statements of cash flows and consolidated statements of stockholders' equity, for the periods presented in accordance with accounting principles generally accepted in the United States ("GAAP"). The consolidated balance sheet at December 31, 2015, has been derived from the audited consolidated financial statements at that date. Operating results and cash flows for the nine months ended September 30, 2016 are not necessarily indicative of the results that may be expected for the fiscal year ending December 31, 2016, or any other future period. Certain information and footnote disclosures normally included in annual financial statements prepared in accordance with GAAP have been omitted in accordance with the rules and regulations for interim reporting of the SEC. These interim consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2015, and other forms filed with the SEC from time to time.

Reclassifications

In order to provide comparability between periods presented, "interest income", "loss on sale of business", "loss on debt extinguishment and termination of derivative instruments" and "other income (expense), net" have been combined within "other expense, net" in the previously reported consolidated statements of comprehensive income to conform to presentation of the current period. See Note 7 to these consolidated financial statements for additional details.

Basis of consolidation

The consolidated financial statements include the accounts of Blackbaud, Inc. and its wholly-owned subsidiaries. All significant intercompany balances and transactions have been eliminated in consolidation.

Use of estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions. These estimates and assumptions affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, as well as the reported amounts of revenues and expenses during the reporting periods. On an ongoing basis, we reconsider and evaluate our estimates and assumptions, including those that impact revenue recognition, long-lived and intangible assets including goodwill, stock-based compensation, the provision for income taxes, deferred taxes, capitalization of software development costs and related amortization, our allowances for sales returns and doubtful accounts, deferred sales commissions and

professional services costs, valuation

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Blackbaud, Inc.

Notes to consolidated financial statements (continued)

(Unaudited)

of derivative instruments, accounting for business combinations and loss contingencies. Changes in the facts or circumstances underlying these estimates could result in material changes and actual results could materially differ from these estimates.

Revenue recognition

Our revenue is primarily generated from the following sources: (i) charging for the use of our software solutions in cloud-based and hosted environments; (ii) providing software maintenance and support services; (iii) providing professional services including implementation, training, consulting, analytic, hosting and other services; (iv) providing transaction and payment processing services; and (v) selling perpetual licenses of our software solutions. We recognize revenue when all of the following conditions are met:

- Persuasive evidence of an arrangement exists;
- The solutions or services have been delivered;
- The fee is fixed or determinable; and
- Collection of the resulting receivable is probable.

Determining whether and when these criteria have been met can require significant judgment and estimates. We deem acceptance of a contract to be evidence of an arrangement. Delivery of our services occurs when the services have been performed. Delivery of our solutions occurs when the solution is shipped or transmitted, and title and risk of loss have transferred to the customers. Our typical arrangements do not include customer acceptance provisions; however, if acceptance provisions are provided, delivery is deemed to occur upon acceptance. We consider the fee to be fixed or determinable unless the fee is subject to refund or adjustment or is not payable within our standard payment terms. Payment terms greater than 90 days are considered to be beyond our customary payment terms. Collection is deemed probable if we expect that the customer will be able to pay amounts under the arrangement as they become due. If we determine that collection is not probable, we defer revenue recognition until collection. Revenue is recognized net of actual and estimated sales returns and allowances.

We follow guidance provided in ASC 605-45, Principal Agent Considerations, which states that determining whether a company should recognize revenue based on the gross amount billed to a customer or the net amount retained is a matter of judgment that depends on the facts and circumstances of the arrangement and that certain factors should be considered in the evaluation.

Subscriptions

We provide software solutions to customers which are available for use in cloud-based subscription arrangements without licensing perpetual rights to the software (“cloud-based solutions”). Revenue from cloud-based solutions is recognized ratably beginning on the activation date over the term of the agreement, which generally ranges from one to three years. Any revenue related to upfront activation or set-up fees is deferred and recognized ratably over the estimated period that the customer benefits from the related cloud-based solution. Direct and incremental costs related to upfront activation or set-up activities for cloud-based solutions are capitalized until the cloud-based solution is deployed and in use, and then expensed ratably over the estimated period that the customer benefits from the related cloud-based solution.

We provide hosting services to customers who have purchased perpetual rights to certain of our software solutions (“hosting services”). Revenue from hosting services, online training programs as well as subscription-based analytic services such as data enrichment and data management services, is recognized ratably beginning on the activation date over the term of the agreement, which generally ranges from one to three years. Any related set-up fees are recognized ratably over the estimated period that the customer benefits from the related hosting service. The estimated period of benefit is evaluated on an annual basis using historical customer retention information by solution or service.

For arrangements that have multiple elements and do not include software licenses, we allocate arrangement consideration at the inception of the arrangement to those elements that qualify as separate units of accounting. The

arrangement consideration is allocated to the separate units of accounting based on relative selling price method in accordance with

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Blackbaud, Inc.

Notes to consolidated financial statements (continued)

(Unaudited)

the selling price hierarchy, which includes: (i) vendor specific objective evidence (“VSOE”) of fair value if available; (ii) third-party evidence (“TPE”) if VSOE is not available; and (iii) best estimate of selling price (“BESP”) if neither VSOE nor TPE is available. In general, we use VSOE to allocate the selling price to subscription and service deliverables.

We offer certain payment processing services with the assistance of third-party vendors. In general, when we are the principal in a transaction based on the predominant weighting of factors identified in ASC 605-45, we record the revenue and related costs on a gross basis. Otherwise, we net the cost of revenue associated with the service against the gross amount billed to the customer and record the net amount as revenue.

Revenue from transaction processing services is recognized when the service is provided and the amounts are determinable. Revenue directly associated with processing donations for customers are included in subscriptions revenue.

Maintenance

We recognize revenue from maintenance services ratably over the term of the arrangement, generally one year at contract inception with annual renewals thereafter. Maintenance contracts are at rates that vary according to the level of the maintenance program associated with the software solution and are generally renewable annually. Maintenance contracts may also include the right to unspecified solution upgrades on an if-and-when available basis. Certain incremental support services are sold in prepaid units of time and recognized as revenue upon their usage.

Services

We generally bill consulting, installation and implementation services based on hourly rates plus reimbursable travel-related expenses. Revenue is recognized for these services over the period the services are delivered.

We recognize analytic services revenue from donor prospect research engagements, the sale of lists of potential donors, benchmarking studies and data modeling service engagements upon delivery. In arrangements where we provide customers the right to updated information during the contract period, revenue is recognized ratably over the contract period.

We sell fixed-rate programs, which permit customers to attend unlimited training over a specified contract period, typically one year, subject to certain restrictions, and revenue in those cases is recognized ratably over the contract period. Additionally, we sell training at a fixed rate for each specific class at a per attendee price or at a packaged price for several attendees, and recognize the related revenue upon the customer attending and completing training.

License fees

We sell perpetual software licenses with maintenance, varying levels of professional services and, in certain instances, with hosting services. We allocate revenue to each of the elements in these arrangements using the residual method under which we first allocate revenue to the undelivered elements, typically the non-software license components, based on VSOE of fair value of the various elements. We determine VSOE of fair value of the various elements using different methods. VSOE of fair value for maintenance services associated with software licenses is based upon renewal rates stated in the arrangements with customers, which demonstrate a consistent relationship of maintenance pricing as a percentage of the contractual license fee. VSOE of fair value of professional services and other solutions and services is based on the average selling price of these same solutions and services to other customers when sold on a stand-alone basis. Any remaining revenue is allocated to the delivered elements, which is normally the software license in the arrangement. In general, revenue is recognized for software licenses upon delivery to our customers. When a software license is sold with software customization services, generally the services are to provide the customer assistance in creating special reports and other enhancements that will improve operational efficiency and/or help to support business process improvements. These services are generally not essential to the functionality of the software and the related revenues are recognized either as the services are delivered or upon completion. However, when software customization services are considered essential to the functionality of the software, we recognize

revenue for both the software license and the services using the percentage-of-completion method.

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Blackbaud, Inc.

Notes to consolidated financial statements (continued)  
(Unaudited)

Deferred revenue

To the extent that our customers are billed for the above described solutions and services in advance of delivery, we record such amounts in deferred revenue. Generally, our subscription and maintenance customers are billed one year in advance.

Fair value measurements

We measure certain financial assets and liabilities at fair value on a recurring basis, including derivative instruments. Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability (an exit price) in an orderly transaction between market participants at the measurement date. An active market is defined as a market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis. We use a three-tier fair value hierarchy to measure fair value. This hierarchy prioritizes the inputs into three broad levels as follows:

Level 1 - Quoted prices for identical assets or liabilities in active markets;

Level 2 - Quoted prices for similar assets and liabilities in active markets, quoted prices for identical or similar assets in markets that are not active, and model-derived valuations in which all significant inputs and significant value drivers are observable in active markets; and

Level 3 - Valuations derived from valuation techniques in which one or more significant inputs are unobservable.

Our financial assets and liabilities are classified in their entirety within the hierarchy based on the lowest level of input that is significant to fair value measurement. Changes to a financial asset's or liability's level within the fair value hierarchy are determined as of the end of a reporting period. All methods of assessing fair value result in a general approximation of value, and such value may never actually be realized.

Earnings per share

We compute basic earnings per share by dividing net income available to common stockholders by the weighted average number of common shares outstanding during the period. Diluted earnings per share is computed by dividing net income available to common stockholders by the weighted average number of common shares and dilutive potential common shares outstanding during the period. Diluted earnings per share reflect the assumed exercise, settlement and vesting of all dilutive securities using the "treasury stock method" except when the effect is anti-dilutive. Potentially dilutive securities consist of shares issuable upon the exercise of stock options, settlement of stock appreciation rights and vesting of restricted stock awards and units.

Recently adopted accounting pronouncements

In September 2015, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2015-16, Simplifying the Accounting for Measurement-Period Adjustments (ASU 2015-16). ASU 2015-16 requires for acquirers in business combinations to recognize adjustments to provisional amounts identified during measurement periods in the reporting periods in which adjusted amounts are determined. The update requires that acquirers record, in the same period's financial statements, the effect on earnings of changes in depreciation, amortization or other income effects, if any, resulting from changes in provisional amounts, calculated as if the accounting had been completed at acquisition date. The update also requires separate income statement presentation or note disclosure of amounts recorded in current period earnings by line item that would have been recorded in previous reporting periods if the provisional amount adjustments had been recognized at the acquisition date (requirements to retrospectively account for those adjustments have been eliminated). The guidance is effective for annual reporting periods beginning after December 15, 2015, including interim periods within that reporting period. Amendments in this update should be applied prospectively to adjustments to provisional amounts that occur after its effective date, with earlier application permitted for financial statements that have not been issued. We adopted ASU 2015-16 on January 1, 2016. See Note 3 to these consolidated financial statements for details of any immaterial measurement



period adjustments.

In April 2015, the FASB issued ASU No. 2015-05, Intangibles - Goodwill and Other - Internal-Use Software (Subtopic 350-40) - Customer's Accounting for Fees Paid in a Cloud Computing Arrangement (ASU 2015-05). The amendments in this update provide guidance to customers about whether a cloud computing arrangement includes a software license.

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Notes to consolidated financial statements (continued)

(Unaudited)

If a cloud computing arrangement includes a software license, the update specifies that the customer should account for the software license element of the arrangement consistent with the acquisition of other software licenses. The update further specifies that the customer should account for a cloud computing arrangement as a service contract if the arrangement does not include a software license. An entity can elect to adopt the amendments either (1) prospectively to all arrangements entered into or materially modified after the effective date or (2) retrospectively. We adopted ASU 2015-05 on January 1, 2016 on a prospective basis and it did not have a material impact on our consolidated financial statements.

In April 2015, the FASB issued ASU 2015-03, Interest - Imputation of Interest - Simplifying the Presentation of Debt Issuance Costs (ASU 2015-03). ASU 2015-03 sets forth a requirement that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent with debt discounts. The recognition and measurement guidance for debt issuance costs is not affected by the amendments in this update. An entity should apply the new guidance on a retrospective basis, wherein the balance sheet of each individual period presented is adjusted to reflect the period-specific effects of applying the new guidance. We adopted ASU 2015-03 on January 1, 2016 and retrospectively restated "other assets" and "debt, net of current portion", which had the effect of reducing each of those respective line items in our December 31, 2015 consolidated balance sheet by approximately \$0.5 million.

In March 2016, the FASB issued ASU 2016-09, Compensation — Stock Compensation (Topic 718), Improvements to Employee Share-Based Payment Accounting (ASU 2016-09). The new guidance requires excess tax benefits and tax deficiencies to be recorded in the income statement when the awards vest or are settled and provides an accounting policy election to account for forfeitures as they occur. In addition, cash flows related to excess tax benefits will no longer be separately classified as a financing activity apart from other income tax cash flows within operating activities. The standard also allows entities to repurchase more of an employee's shares for tax withholding purposes without triggering liability accounting and clarifies that all cash payments made on an employee's behalf for withheld shares should be presented as a financing activity on the statements of cash flows. The new standard is effective for fiscal years beginning after December 15, 2016, with early adoption permitted.

We early adopted ASU 2016-09 during the three months ended September 30, 2016, which requires us to reflect any adjustments as of January 1, 2016, the beginning of the annual period that includes the interim period of adoption. Upon adoption, we elected to account for forfeitures as they occur using a modified retrospective transition method, which resulted in a cumulative-effect adjustment of \$0.9 million to reduce our January 1, 2016 opening retained earnings balance. The following table summarizes the impact to our consolidated balance sheet, including the net amount charged to retained earnings as of January 1, 2016:

(dollars in thousands)	As of January 1, 2016	
	Balance sheet location	Amount
Decrease in deferred tax liabilities related to the cumulative effect adjustment from our election to recognize forfeitures as they occur rather than applying an estimated forfeiture rate	Deferred tax liability	\$(606 )
Increase in additional paid-in capital resulting from our election to recognize forfeitures as they occur	Additional paid-in capital	\$1,540
Net charge to retained earnings for cumulative effect adjustment from adoption of ASU 2016-09	Retained earnings	\$(934 )

We elected to retrospectively apply the changes in presentation to the statements of cash flows and no longer classify excess tax benefits as a financing activity, which increased both net cash provided by operating activities and net cash used in financing activities by \$1.5 million for the nine months ended September 30, 2015. The presentation

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requirements for cash flows related to employee taxes paid for withheld shares increased both net cash provided by operating activities and net cash used in financing activities for the nine months ended September 30, 2015 by \$2.7 million, as such cash flows were historically presented within operating cash flows.

Adoption of the new standard resulted in the recognition of additional stock-based compensation expense of approximately \$0.6 million and \$1.0 million for the three and nine months ended September 30, 2016, respectively, as well as the recognition of excess tax benefits in our provision for income taxes rather than paid-in capital of \$1.6 million and \$4.3

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Blackbaud, Inc.

Notes to consolidated financial statements (continued)

(Unaudited)

million for the three and nine months ended September 30, 2016, respectively. The adoption of ASU 2016-09 impacted our previously reported quarterly results for fiscal year 2016 as follows:

Consolidated balance sheets:

(dollars in thousands)	As of March 31, 2016		As of June 30, 2016	
	As	As	As	As
	Reported	Adjusted	Reported	Adjusted
Additional paid-in capital	\$285,376	\$285,606	\$294,810	\$294,019
Retained earnings	\$134,192	\$134,500	\$136,338	\$137,893

Consolidated statements of comprehensive income:

(dollars in thousands, except per share amounts)	Three months ended March 31, 2016		Three months ended June 30, 2016	
	As	As	As	As
	Reported	Adjusted	Reported	Adjusted
Income tax provision	\$2,664	\$1,595	\$3,598	\$1,778
Net income	\$4,995	\$6,237	\$7,813	\$9,060
Basic earnings per share	\$0.11	\$0.14	\$0.17	\$0.20
Diluted earnings per share	\$0.11	\$0.13	\$0.17	\$0.19
Diluted weighted average shares outstanding	46,757,458	47,064,164	46,927,626	47,263,844

Consolidated statements of cash flows:

(dollars in thousands)	Three months ended March 31, 2016		Six months ended June 30, 2016	
	As	As	As	As
	Reported	Adjusted	Reported	Adjusted
Net cash provided by operating activities	\$104	\$6,757	\$37,987	\$48,753
Net cash provided by (used in) financing activities	\$9,546	\$2,893	\$(13,852)	\$(24,618)
Recently issued accounting pronouncements				

In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842) (ASU 2016-02). ASU 2016-02 will require lessees to record most leases on their balance sheets but recognize expenses in the income statement in a manner similar to current guidance. The updated guidance also eliminates certain real estate-specific provisions and changes the guidance on sale-leaseback transactions, initial direct costs and lease executory costs for all entities. For lessors, the standard modifies the classification criteria and the accounting for sales-type and direct financing leases. All entities will classify leases to determine how to recognize lease-related revenue and expense. Classification will continue to affect amounts that lessors record on the balance sheet. ASU 2016-02 is effective for annual periods beginning after December 15, 2018, and interim periods within those years. Early adoption is permitted. Upon adoption, entities will be required to use a modified retrospective approach for leases that exist or are entered into after the beginning of the earliest comparative period in the financial statements. The modified retrospective approach includes a number of optional practical expedients that entities may elect to apply. We expect ASU 2016-02 will impact our consolidated financial statements and are currently evaluating the extent of the impact that implementation of this standard will have on adoption.

In May 2014, the FASB issued ASU 2014-09, Revenue from Contracts with Customers (Topic 606) (ASU 2014-09). ASU 2014-09 outlines a single comprehensive model for entities to use in accounting for revenue arising from

contracts with customers and will replace most existing revenue recognition guidance in GAAP when it becomes effective. ASU 2014-09 was originally effective for fiscal years and interim periods within those years beginning after December 15, 2016. An entity should apply ASU 2014-09 either retrospectively to each prior reporting period presented or retrospectively with the cumulative effect of initially applying the ASU recognized as an adjustment to the opening balance of retained earnings at the date of initial application. In July 2015, the FASB decided to delay the effective date of the new standard for one year. The new standard now requires application no later than annual reporting periods beginning after December 15,

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Blackbaud, Inc.

Notes to consolidated financial statements (continued)

(Unaudited)

2017, including interim reporting periods therein; however, public entities are permitted to elect to early adopt the new standard as of the original effective date. In March 2016, the FASB finalized amendments to the guidance in the new standard to clarify whether an entity is a principal or an agent in a revenue transaction. In April 2016, the FASB finalized additional amendments to the guidance in the new standard to clarify the accounting for licenses of intellectual property and identifying performance obligations. We expect the adoption of ASU 2014-09 will impact our consolidated financial statements. We are currently evaluating implementation methods and the extent of the impact that implementation of this standard and the recently issued clarifying amendments will have upon adoption.

## 3. Business Combinations

## 2016 Acquisition

## Attentive.ly

On July 11, 2016, we acquired all of the outstanding equity, including all voting equity interests of Good+Geek, Inc., a Delaware corporation doing business as "Attentive.ly." Attentive.ly provides social media capabilities allowing organizations to conduct social listening, identify key influencers and drive engagement through its cloud solution. The acquisition accelerates our ability to deliver these capabilities to our customers. We acquired Attentive.ly for \$3.9 million in cash, net of closing adjustments. Of that purchase price, \$1.3 million was allocated to the acquired finite-lived intangible technology asset, which will be amortized over its estimated useful life of five years. The estimated amount of goodwill arising from the acquisition was assigned to the General Markets Business Unit ("GMBU") reporting segment and the Enterprise Customer Business Unit ("ECBU") reporting segment was \$1.9 million and \$0.4 million, respectively. None of the goodwill is deductible for tax purposes. The carrying amounts of all other assets acquired and liabilities assumed are insignificant and approximate their estimated fair values. The assets and liabilities recorded for the acquisition of Attentive.ly were based on preliminary valuations and the estimates and assumptions are subject to change as we obtain additional information during the measurement period, which may be up to one year from the acquisition date. We included the operating results of Attentive.ly, which are insignificant, in our consolidated financial statements from the date of acquisition. We do not expect this business combination to have a material effect on our consolidated financial position, results of operations or cash flows. We determined that the Attentive.ly acquisition was not a material business combination; therefore, pro forma disclosures have not been presented.

## 2015 Acquisition

## Smart Tuition

On October 2, 2015, we completed our acquisition of all of the outstanding equity, including all voting equity interests, of Smart, LLC ("Smart Tuition"). Smart Tuition is a leading provider of payment software and services for private schools and parents. The acquisition of Smart Tuition further expanded our offerings in the K-12 technology sector. We acquired Smart Tuition for \$187.3 million in cash, net of closing adjustments including an adjustment of approximately \$0.5 million during the three months ended March 31, 2016. We received the proceeds from these closing adjustments during the three months ended September 30, 2016. On October 2, 2015, we drew down a \$186.0 million revolving credit loan under our 2014 Credit Facility (as defined in Note 8 below) to finance the acquisition of Smart Tuition. As a result of the acquisition, Smart Tuition has become a wholly-owned subsidiary of ours. We included the operating results of Smart Tuition in our consolidated financial statements within our GMBU reporting segment from the date of acquisition. For the three months ended September 30, 2016, Smart Tuition's total revenue and operating income included in our consolidated financial statements was \$10.3 million and \$1.0 million, respectively. For the nine months ended September 30, 2016, Smart Tuition's total revenue and operating income included in our consolidated financial statements was \$27.7 million and \$2.8 million, respectively.



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Blackbaud, Inc.

Notes to consolidated financial statements (continued)

(Unaudited)

The following table summarizes the allocation of the purchase price based on the estimated fair value of the assets acquired and the liabilities assumed:

(dollars in thousands)	Purchase Price Allocation
Net working capital, excluding deferred revenue	\$ 202
Property and equipment	2,457
Deferred revenue	(6,500 )
Deferred tax asset	2,637
Intangible assets	97,800
Goodwill	90,376
Total purchase price <sup>(1)</sup>	\$ 186,972

(1) The purchase price differs from the net cash outlay of \$187.3 million due to certain insignificant acquisition-related expenses included therein.

The estimated fair value of accounts receivable acquired approximates the contractual value of \$2.8 million. The estimated goodwill recognized is attributable primarily to the opportunities for expected synergies from combining operations and the assembled workforce of Smart Tuition, all of which was assigned to our GMBU reporting segment. Approximately \$86.3 million of the goodwill arising from the acquisition is deductible for income tax purposes. We finalized the purchase price allocation for Smart Tuition, including the valuation of assets acquired and liabilities assumed, during the third quarter of 2016. All measurement period adjustments recorded were not significant.

The Smart Tuition acquisition resulted in the identification of the following identifiable intangible assets:

	Intangible assets acquired (in thousands)	Weighted average amortization period (in years)
Customer relationships	\$ 72,300	17
Marketing assets	1,200	3
Acquired technology	22,100	7
Non-compete agreements	2,200	5
Total intangible assets	\$ 97,800	14

The estimated fair values of the finite-lived intangible assets were based on variations of the income approach, which estimates fair value based on the present value of cash flows that the assets are expected to generate which included the relief-from-royalty method, incremental cash flow method including the with and without method and excess earnings method, depending on the intangible asset being valued. The method of amortization of identifiable finite-lived intangible assets is based on the expected pattern in which the estimated economic benefits of the respective assets are consumed or otherwise used up. Customer relationships and acquired technology are being amortized on an accelerated basis while marketing assets and non-compete agreements are being amortized on a straight-line basis.





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Blackbaud, Inc.

Notes to consolidated financial statements (continued)

(Unaudited)

The following unaudited pro forma condensed combined consolidated results of operations assume that the acquisition of Smart Tuition occurred on January 1, 2014. This unaudited pro forma financial information does not reflect any adjustments for anticipated synergies resulting from the acquisition and should not be relied upon as being indicative of the historical results that would have been attained had the transaction been consummated as of January 1, 2014, or of the results that may occur in the future. The unaudited pro forma information reflects adjustments for amortization of intangibles related to the fair value adjustments of the assets acquired, write-down of acquired deferred revenue to fair value, additional interest expense related to the financing of the transaction and the related tax effects of the adjustments.

	Three months ended September 30, 2015	Nine months ended September 30, 2015
(dollars in thousands, except per share amounts)		
Revenue	\$ 168,190	\$ 488,172
Net income	\$ 6,056	\$ 16,579
Basic earnings per share	\$ 0.13	\$ 0.36
Diluted earnings per share	\$ 0.13	\$ 0.36

## 4. Earnings Per Share

The following table sets forth the computation of basic and diluted earnings per share:

	Three months ended September 30, 2016		Nine months ended September 30, 2016	
(dollars in thousands, except per share amounts)				
Numerator:				
Net income	\$8,934	\$ 7,911	\$24,231	\$ 19,238
Denominator:				
Weighted average common shares	46,159,956	46,16,832	46,078,306	46,576,029
Add effect of dilutive securities:				
Stock-based awards	1,234,197	1,509,882	1,190,168	1,271,167
Weighted average common shares assuming dilution	47,394,153	47,676,714	47,268,474	47,847,196
Earnings per share:				
Basic	\$0.19	\$ 0.17	\$0.53	\$ 0.42
Diluted	\$0.19	\$ 0.17	\$0.51	\$ 0.41
Anti-dilutive shares excluded from calculations of diluted earnings per share	1,723	9,765	3,766	18,658

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Blackbaud, Inc.

Notes to consolidated financial statements (continued)

(Unaudited)

## 5. Fair Value Measurements

Recurring fair value measurements

Financial assets and liabilities measured at fair value on a recurring basis consisted of the following, as of:

(dollars in thousands)	Fair value measurement using			Total
	Level 1	Level 2	Level 3	
Fair value as of September 30, 2016				
Financial liabilities:				
Derivative instruments <sup>(1)</sup>	\$	-\$ 654	\$	-\$654
Total financial liabilities	\$	-\$ 654	\$	-\$654

Fair value as of December 31, 2015

Financial assets:

Derivative instruments <sup>(1)</sup>	\$	-\$ 406	\$	-\$406
Total financial assets	\$	-\$ 406	\$	-\$406

Fair value as of December 31, 2015

Financial liabilities:

Derivative instruments <sup>(1)</sup>	\$	-\$ 438	\$	-\$438
Total financial liabilities	\$	-\$ 438	\$	-\$438

The fair value of our interest rate swaps was based on model-driven valuations using LIBOR rates, which are (1) observable at commonly quoted intervals. Accordingly, our interest rate swaps are classified within Level 2 of the fair value hierarchy.

We believe the carrying amounts of our cash and cash equivalents, restricted cash due to customers, accounts receivable, trade accounts payable, accrued expenses and other current liabilities and due to customers approximate their fair values at September 30, 2016 and December 31, 2015, due to the immediate or short-term maturity of these instruments.

We believe the carrying amount of our debt approximates its fair value at September 30, 2016 and December 31, 2015, as the debt bears interest rates that approximate market value. As LIBOR rates are observable at commonly quoted intervals, our debt is classified within Level 2 of the fair value hierarchy.

We did not transfer any assets or liabilities among the levels within the fair value hierarchy during the nine months ended September 30, 2016. Additionally, we did not hold any Level 3 assets or liabilities during the nine months ended September 30, 2016.

## Non-recurring fair value measurements

Assets and liabilities that are measured at fair value on a non-recurring basis include intangible assets and goodwill, which are recognized at fair value during the period in which an acquisition is completed, from updated estimates and assumptions during the measurement period, or when they are considered to be impaired. These non-recurring fair value measurements, primarily for intangible assets acquired, were based on Level 3 unobservable inputs. In the event of an impairment, we determine the fair value of the goodwill and intangible assets using a discounted cash flow approach, which contains significant unobservable inputs and, therefore, is considered a Level 3 fair value

measurement. The unobservable inputs in the analysis generally include future cash flow projections and a discount rate.

There were no non-recurring fair value adjustments to intangible assets and goodwill during the nine months ended September 30, 2016, except for certain insignificant business combination accounting adjustments to the initial fair value estimates of the Smart Tuition assets acquired and liabilities assumed at the acquisition date from updated information

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Blackbaud, Inc.

Notes to consolidated financial statements (continued)

(Unaudited)

obtained during the measurement period. See Note 3 to these consolidated financial statements for additional details. The measurement period of a business combination may be up to one year from the acquisition date. We record any measurement period adjustments to the fair value of assets acquired and liabilities assumed, with the corresponding offset to goodwill.

## 6. Goodwill and Other Intangible Assets

The change in goodwill for each reportable segment (as defined in Note 14 below) during the nine months ended September 30, 2016, consisted of the following:

(dollars in thousands)	ECBU	GMBU	IBU	Total
Balance at December 31, 2015	\$240,494	\$190,976	\$4,979	\$436,449
Additions related to current year business combination	426	1,882	34	2,342
Adjustments related to prior year business combination	—	(182)	—	(182)
Effect of foreign currency translation	—	—	(159)	(159)
Balance at September 30, 2016	\$240,920	\$192,676	\$4,854	\$438,450

## Amortization expense

Amortization expense related to finite-lived intangible assets acquired in business combinations is allocated to cost of revenue on the consolidated statements of comprehensive income based on the revenue stream to which the asset contributes, except for marketing assets and non-compete agreements, for which the associated amortization expense is included in operating expenses.

The following table summarizes amortization expense:

(dollars in thousands)	Three months ended		Nine months ended	
	September 30, 2016	September 30, 2015	September 30, 2016	September 30, 2015
Included in cost of revenue:				
Cost of subscriptions	\$7,790	\$5,761	\$23,454	\$17,300
Cost of maintenance	1,332	1,000	3,996	3,160
Cost of services	655	698	1,965	2,007
Cost of license fees and other	85	86	255	283
Total included in cost of revenue	9,862	7,545	29,670	22,750
Included in operating expenses	687	524	2,147	1,536
Total amortization of intangibles from business combinations	\$10,549	\$8,069	\$31,817	\$24,286

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Blackbaud, Inc.

Notes to consolidated financial statements (continued)

(Unaudited)

The following table outlines the estimated future amortization expense for each of the next five years for our finite-lived intangible assets as of September 30, 2016:

(dollars in thousands)	Amortization
Years ending December 31, expense	
2016 - remaining	\$ 10,581
2017	41,716
2018	40,004
2019	36,544
2020	27,979
Total	\$ 156,824

## 7. Consolidated Financial Statement Details

## Prepaid expenses and other assets

(dollars in thousands)	September 30, 2016	December 31, 2015
Deferred sales commissions	\$ 34,489	\$ 30,141
Prepaid software maintenance	17,488	15,308
Deferred professional services costs	2,113	3,603
Taxes, prepaid and receivable	4,892	9,121
Deferred tax asset	3,135	2,869
Prepaid royalties	1,431	1,767
Other assets	6,699	6,758
Total prepaid expenses and other assets	70,247	69,567
Less: Long-term portion	18,102	20,901
Prepaid expenses and other current assets	\$ 52,145	\$ 48,666

## Accrued expenses and other liabilities

(dollars in thousands)	September 30, 2016	December 31, 2015
Accrued bonuses	\$ 14,478	\$ 24,591
Accrued commissions and salaries	6,620	8,391
Taxes payable	3,131	3,923
Deferred rent liabilities	4,164	4,070
Lease incentive obligations	4,616	4,734
Unrecognized tax benefit	3,029	3,147
Customer credit balances	4,615	3,515
Accrued vacation costs	2,398	2,446
Accrued health care costs	2,049	2,356
Other liabilities	6,808	7,911
Total accrued expenses and other liabilities	51,908	65,084
Less: Long-term portion	7,467	7,623
Accrued expenses and other current liabilities	\$ 44,441	\$ 57,461

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Blackbaud, Inc.

Notes to consolidated financial statements (continued)

(Unaudited)

## Deferred revenue

(dollars in thousands)	September 30, December 31,	
	2016	2015
Subscriptions	\$ 143,462	\$ 122,524
Maintenance	80,536	85,901
Services	28,533	28,517
License fees and other	2,215	393
Total deferred revenue	254,746	237,335
Less: Long-term portion	6,594	7,119
Deferred revenue, current portion	\$ 248,152	\$ 230,216
Other (expense) income, net		

(dollars in thousands)	Three months ended		Nine months ended	
	September 30,		September 30,	
	2016	2015	2016	2015
Interest income	\$224	\$8	\$463	\$23
Loss on sale of business	—	—	—	(1,976 )
Other (expense) income, net	(239 )	184	(648 )	584
Other (expense) income, net	\$(15 )	\$192	\$(185)	\$(1,369)

## 8. Debt

The following table summarizes our debt balances and the related weighted average effective interest rates, which includes the effect of interest rate swap agreements.

(dollars in thousands)	Debt balance at		Weighted average effective interest rate at		
	September 30, 2016	December 31, 2015	September 30, 2016	December 31, 2015	
Credit facility:					
Revolving credit loans	\$212,600	\$242,900	2.34	%2.15	%
Term loans	164,063	167,344	2.58	%2.51	%
Total debt	376,663	410,244	2.44	%2.30	%
Less: Unamortized debt discount	1,646	2,157			
Less: Debt, current portion	4,375	4,375	2.34	%2.11	%
Debt, net of current portion	\$370,642	\$403,712	2.44	%2.30	%

## Summary of the 2014 Credit Facility

In February 2014, we entered into a five-year \$325.0 million credit facility (the “2014 Credit Facility”) and drew \$175.0 million on a term loan upon closing, which was used to repay all amounts outstanding under the 2012 Credit Facility. The 2014 Credit Facility includes the following facilities: (i) a dollar and a designated currency revolving credit facility with sublimits for letters of credit and swingline loans (the “2014 Revolving Facility”) and (ii) a term loan facility (the “2014 Term Loan”).

In connection with our entry into the 2014 Credit Facility, we paid \$2.5 million in financing costs, of which \$1.1 million were capitalized and, together with a portion of the unamortized deferred financing costs from prior facilities, are being amortized into interest expense over the term of the new facility using the effective interest method. As of

September 30,

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Blackbaud, Inc.

Notes to consolidated financial statements (continued)

(Unaudited)

2016 and December 31, 2015, deferred financing costs totaling \$0.7 million and \$0.9 million, respectively, were included in other assets on the consolidated balance sheet.

The 2014 Credit Facility is secured by the stock and limited liability company interests of certain of our subsidiaries and is guaranteed by our material domestic subsidiaries.

Amounts borrowed under the dollar tranche revolving credit loans and term loan under the 2014 Credit Facility bear interest at a rate per annum equal to, at our option, (a) a base rate equal to the highest of (i) the prime rate, (ii) federal funds rate plus 0.50% and (iii) one month LIBOR plus 1.00% (the "Base Rate"), in addition to a margin of 0.00% to 0.50%, or (b) LIBOR rate plus a margin of 1.00% to 1.50%.

We also pay a quarterly commitment fee on the unused portion of the 2014 Revolving Facility from 0.15% to 0.225% per annum, depending on our net leverage ratio. At September 30, 2016, the commitment fee was 0.225%.

The 2014 Term Loan requires periodic principal payments. The balance of the 2014 Term Loan and any amounts drawn on the 2014 Revolving Facility are due upon maturity of the 2014 Credit Facility in February 2019. We evaluate the classification of our debt as current or non-current based on the required annual maturities of the 2014 Credit Facility.

The 2014 Credit Facility includes financial covenants related to the net leverage ratio and interest coverage ratio, as well as restrictions on our ability to declare and pay dividends and our ability to repurchase shares of our common stock. At September 30, 2016, we were in compliance with our debt covenants under the 2014 Credit Facility.

Financing for MicroEdge acquisition

The 2014 Credit Facility includes an option to request increases in the revolving commitments and/or request additional term loans in an aggregate principal amount of up to \$200.0 million. On October 1, 2014, we exercised this option, and certain lenders agreed, to increase the revolving credit commitments by \$100.0 million (the "October 2014 Additional Revolving Credit Commitments") such that for the period commencing October 1, 2014, the aggregate revolving credit commitments available were \$250.0 million. The October 2014 Additional Revolving Credit Commitments have the same terms as the existing revolving credit commitments.

On October 1, 2014, we drew down a \$140.0 million revolving credit loan under the 2014 Credit Facility to finance the acquisition of MicroEdge.

Financing for Smart Tuition acquisition

On July 17, 2015, we again exercised this option and certain lenders agreed to increase the revolving credit commitments by an additional \$100.0 million (the "July 2015 Additional Revolving Credit Commitments") such that commencing July 17, 2015, the aggregate revolving credit commitments available were \$350.0 million. The July 2015 Additional Revolving Credit Commitments have the same terms as the existing revolving credit commitments.

On October 2, 2015, we drew down a \$186.0 million revolving credit loan under the 2014 Credit Facility to finance the acquisition of Smart Tuition.

As of September 30, 2016, the required annual maturities related to the 2014 Credit Facility were as follows:

Years ending December 31, Annual (dollars in thousands)	maturities
2016 - remaining	\$ 1,094
2017	4,375
2018	4,375
2019	366,819
2020	—
Thereafter	—
Total required maturities	\$ 376,663



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Blackbaud, Inc.

Notes to consolidated financial statements (continued)

(Unaudited)

9. Derivative Instruments

We use derivative instruments to manage our variable interest rate risk. In March 2014, we entered into an interest rate swap agreement (the "March 2014 Swap Agreement"), which effectively converts portions of our variable rate debt under the 2014 Credit Facility to a fixed rate for the term of the swap agreement. The initial notional value of the March 2014 Swap Agreement was \$125.0 million with an effective date beginning in March 2014. In March 2017, the notional value of the March 2014 Swap Agreement will decrease to \$75.0 million for the remaining term through February 2018. We designated the March 2014 Swap Agreement as a cash flow hedge at the inception of the contract.

In October 2015, we entered into an additional interest rate swap agreement (the "October 2015 Swap Agreement"), which effectively converts portions of our variable rate debt under the 2014 Credit Facility to a fixed rate for the term of the October 2015 Swap Agreement. The notional value of the October 2015 Swap Agreement was \$75.0 million with an effective date beginning in October 2015 and maturing in February 2018. We designated the October 2015 Swap Agreement as a cash flow hedge at the inception of the contract.

The fair values of our derivative instruments were as follows as of:

(dollars in thousands)	Balance sheet location	September 30, 2016	December 31, 2015
Derivative instruments designated as hedging instruments:			
Interest rate swap, long-term portion	Other assets	\$ —	\$ 406
Total derivative instruments designated as hedging instruments		\$ —	\$ 406
		September 30, 2016	December 31, 2015
Derivative instruments designated as hedging instruments:			
Interest rate swaps, current portion	Accrued expenses and other current liabilities	\$ —	\$ 2
Interest rate swaps, long-term portion	Other liabilities	654	436
Total derivative instruments designated as hedging instruments		\$ 654	\$ 438

The effects of derivative instruments in cash flow hedging relationships were as follows:

(dollars in thousands)	Gain (loss) recognized in accumulated other comprehensive loss as of	Location of gain (loss) reclassified from accumulated other comprehensive loss into income	Gain (loss) reclassified from other comprehensive loss into income	Three months ended September 30, 2016	Nine months ended September 30, 2016
Interest rate swaps	\$ (654	) Interest expense	\$ (265)	\$ (875	)
	September 30, 2015		Three months ended September 30, 2015	Nine months ended September 30, 2015	

	ended	ended
	September	September
	30,	30, 2015
	2015	

Interest rate swaps	\$ (1,312 )	Interest expense	\$(373)	\$(1,122 )
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Our policy requires that derivatives used for hedging purposes be designated and effective as a hedge of the identified risk exposure at the inception of the contract. Accumulated other comprehensive income (loss) includes unrealized gains or losses from the change in fair value measurement of our derivative instruments each reporting period and the related income tax expense or benefit. Changes in the fair value measurements of the derivative instruments and the related income tax expense or benefit are reflected as adjustments to accumulated other comprehensive income (loss) until the actual hedged expense is incurred or until the hedge is terminated at which point the unrealized gain (loss) is reclassified from accumulated other comprehensive income (loss) to current earnings. The estimated accumulated other comprehensive loss as of September 30, 2016 that is expected to be reclassified into earnings within the next twelve months is \$0.6 million. There were no ineffective portions of our interest rate swap derivatives during the nine months ended September 30, 2016 and 2015. See Note 13 to these consolidated financial statements for a summary of the changes in accumulated other comprehensive income (loss) by component.

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Blackbaud, Inc.

Notes to consolidated financial statements (continued)

(Unaudited)

10. Commitments and Contingencies

Historical Leases

We lease our headquarters facility under a 15-year lease agreement which was entered into in October 2008, and has two five-year renewal options. The current annual base rent of the lease is \$5.1 million, payable in equal monthly installments. The base rent escalates annually at a rate equal to the change in the consumer price index, as defined in the agreement, but not to exceed 5.5% in any year.

We have a lease for office space in Austin, Texas which terminates on September 30, 2023, and has two five-year renewal options. The current annual base rent of the lease is \$2.7 million. The base rent escalates annually between 2% and 4% based on the terms of the agreement. The rent expense is recorded on a straight-line basis over the length of the lease term. At September 30, 2016, we had a standby letter of credit of \$2.0 million for a security deposit for this lease.

We have provisions in our leases that entitle us to aggregate remaining leasehold improvement allowances of \$4.9 million. These amounts are being recorded as a reduction to rent expense ratably over the terms of the leases. The reductions in rent expense related to these lease provisions during the three months ended September 30, 2016 and 2015 were insignificant. The reductions in rent expense related to these lease provisions during the nine months ended September 30, 2016 and 2015, were \$0.6 million and \$0.6 million, respectively. The leasehold improvement allowances have been included in the table of operating lease commitments below as a reduction in our lease commitments ratably over the then remaining terms of the leases. The timing of the reimbursements for the actual leasehold improvements may vary from the amounts reflected in the table below.

We have also received, and expect to receive through 2016, quarterly South Carolina state incentive payments as a result of locating our headquarters facility in Berkeley County, South Carolina. These amounts are recorded as a reduction of rent expense upon receipt and were \$0.6 million and \$0.6 million for the three months ended September 30, 2016 and 2015, respectively, and \$2.2 million and \$1.8 million for the nine months ended September 30, 2016 and 2015, respectively.

Total rent expense was \$3.1 million and \$2.5 million for the three months ended September 30, 2016 and 2015, respectively, and \$8.6 million and \$7.4 million for the nine months ended September 30, 2016 and 2015, respectively.

Lease for New Headquarters Facility

In May 2016, we entered into a lease agreement for a new headquarters facility to be built in Charleston, South Carolina (the "New Headquarters Facility"). The landlord is responsible for the design, development and construction of the New Headquarters Facility. Construction of the New Headquarters Facility will proceed in two phases. Phase One will include a building with approximately 172,000 rentable square feet, which is expected to be completed in the first quarter of 2018. The lease agreement also grants us a Phase Two option to request that the landlord construct and lease to us a second office building and related improvements. Total rent payments and leasehold improvement allowances for Phase One are estimated to be approximately \$102.0 million and \$12.9 million, respectively, over the life of the lease agreement, plus additional amounts for Phase Two, if applicable. The lease agreement is for a period of twenty years beginning on the date of substantial completion of construction by the landlord, which is estimated to be in the first quarter of 2018, and ending in the first quarter of 2038. The lease agreement provides for four renewal periods of five years each at a base rent equal to the then prevailing market rate for comparable buildings. We expect to receive quarterly South Carolina state incentive payments as a result of locating our headquarters facility in Berkeley County, South Carolina.



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Blackbaud, Inc.

Notes to consolidated financial statements (continued)

(Unaudited)

As of September 30, 2016, the future minimum lease commitments related to lease agreements, net of related lease incentives, were as follows:

Years ending December 31, (dollars in thousands)	Operating leases <sup>(1)</sup>
2016 – remaining	\$3,427
2017	12,531
2018	15,663
2019	15,954
2020	15,309
Thereafter	110,088
Total minimum lease payments	\$172,972

(1) Our future minimum lease commitments related to operating leases do not include payments related to Phase Two of our New Headquarters Facility, as that option had not been exercised as of September 30, 2016.

**Other commitments**

As discussed in Note 8 to these consolidated financial statements, the term loans under the 2014 Credit Facility require periodic principal payments. The balance of the term loans and any amounts drawn on the revolving credit loans are due upon maturity of the 2014 Credit Facility in February 2019.

We utilize third-party technology in conjunction with our solutions and services, with contractual obligations varying in length from one to four years. In certain cases, such arrangements require a minimum annual purchase commitment. As of September 30, 2016, the remaining aggregate minimum purchase commitment under these arrangements was approximately \$35.7 million through 2020.

**Product and service indemnifications**

In the ordinary course of business, we provide certain indemnifications of varying scope to customers against claims of intellectual property infringement made by third parties arising from the use of our solutions or services. If we determine that it is probable that a loss has been incurred related to solution or service indemnifications, any such loss that could be reasonably estimated would be recognized. We have not identified any losses and, accordingly, we have not recorded a liability related to these indemnifications.

**Legal contingencies**

We are subject to legal proceedings and claims that arise in the ordinary course of business. We record an accrual for a contingency when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated. As of September 30, 2016, in our opinion, there was not at least a reasonable possibility that these actions arising in the ordinary course of business will have a material adverse effect upon our consolidated financial position, results of operations or cash flows and, therefore, no material loss contingencies were recorded.

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Blackbaud, Inc.

Notes to consolidated financial statements (continued)

(Unaudited)

## 11. Income Taxes

Our income tax provision and effective income tax rates including the effects of period-specific events, were:

	Three months ended September 30,		Nine months ended September 30,		
(dollars in thousands)	2016	2015	2016	2015	
Income tax provision	\$1,950	\$4,433	\$5,323	\$10,459	
Effective income tax rate	17.9	% 35.9	% 18.0	% 35.2	%

The decreases in our effective income tax rates during the three and nine months ended September 30, 2016, when compared to the same periods in 2015, were primarily due to discrete tax benefits from the early adoption of ASU 2016-09 relating to stock-based compensation. Under ASU 2016-09, excess tax benefits generated upon the settlement or exercise of stock awards are no longer recognized as additional paid-in capital but are instead recognized as a reduction to income tax expense. The remaining impacts to our effective income tax rates for these periods were the estimated benefit to our annual 2016 effective tax rate from federal and state research tax credits that were permanently enacted into law in December 2015 and a discrete tax benefit included in the 2016 periods from statute of limitations expiration, partially offset by the estimated impact to our annual 2016 effective tax rate from Section 162(m) nondeductible compensation.

In addition to the events that impact our effective income tax rate during both the three and nine months ended September 30, 2016, when compared to the same periods in 2015, the decrease in our effective tax rate during the nine months ended September 30, 2016 was also partially offset by a discrete tax benefit included in the 2015 period from the settlement of an IRS audit.

Our effective income tax rate may fluctuate quarterly as a result of factors, including transactions entered into, changes in the geographic distribution of our earnings or losses, our assessment of certain tax contingencies, valuation allowances, and changes in tax law in jurisdictions where we conduct business.

We have deferred tax assets for federal, state, and international net operating loss carryforwards and state tax credits. The federal and state net operating loss carryforwards are subject to various Internal Revenue Code limitations and applicable state tax laws. A portion of the foreign and state net operating loss carryforwards and a portion of state tax credits have a valuation reserve due to the uncertainty of realizing such carryforwards and credits in the future.

The total amount of unrecognized tax benefit that, if recognized, would favorably affect the effective income tax rate, was \$2.2 million and \$2.3 million at September 30, 2016 and December 31, 2015, respectively. We recognize accrued interest and penalties, if any, related to unrecognized tax benefits as a component of income tax expense.

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Blackbaud, Inc.

Notes to consolidated financial statements (continued)

(Unaudited)

## 12. Stock-based Compensation

Stock-based compensation expense is allocated to cost of revenue and operating expenses on the consolidated statements of comprehensive income based on where the associated employee's compensation is recorded. The following table summarizes stock-based compensation expense:

	Three months ended September 30,		Nine months ended September 30,	
	2016	2015	2016	2015
(dollars in thousands)				
Included in cost of revenue:				
Cost of subscriptions	\$318	\$213	\$904	\$681
Cost of maintenance	137	107	391	353
Cost of services	461	449	1,308	1,685
Total included in cost of revenue	916	769	2,603	2,719
Included in operating expenses:				
Sales, marketing and customer success	1,055	768	2,972	2,273
Research and development	1,674	1,145	4,874	3,309
General and administrative	5,173	3,804	14,556	9,598
Total included in operating expenses	7,902	5,717	22,402	15,180
Total stock-based compensation expense	\$8,818	\$6,486	\$25,005	\$17,899

## 13. Stockholders' Equity

## Dividends

Our Board of Directors has adopted a dividend policy, which provides for the distribution to stockholders of a portion of cash generated by us that is in excess of operational needs and capital expenditures. The 2014 Credit Facility limits the amount of dividends payable and certain state laws restrict the amount of dividends distributed.

In February 2016, our Board of Directors approved an annual dividend rate of \$0.48 per share to be made in quarterly payments. Dividend payments are not guaranteed and our Board of Directors may decide, in its absolute discretion, at any time and for any reason, not to declare and pay further dividends. The following table provides information with respect to quarterly dividends of \$0.12 per share paid on common stock during the nine months ended September 30, 2016.

Declaration Date	Dividend per Share	Record Date	Payable Date
February 9, 2016	\$ 0.12	February 26	March 15
April 27, 2016	\$ 0.12	May 27	June 15
August 1, 2016	\$ 0.12	August 26	September 15

On November 1, 2016, our Board of Directors declared a fourth quarter dividend of \$0.12 per share payable on December 15, 2016 to stockholders of record on November 23, 2016.

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Blackbaud, Inc.

Notes to consolidated financial statements (continued)

(Unaudited)

Changes in accumulated other comprehensive loss by component

The changes in accumulated other comprehensive loss by component, consisted of the following:

(dollars in thousands)	Three months ended		Nine months ended	
	September 30, 2016	2015	September 30, 2016	2015
Accumulated other comprehensive loss, beginning of period	\$(1,640)	\$(1,926)	\$(825)	\$(1,032)
By component:				
Gains and losses on cash flow hedges:				
Accumulated other comprehensive loss balance, beginning of period	\$(806)	\$(536)	\$(19)	\$(164)
Other comprehensive income (loss) before reclassifications, net of tax effects of \$(161), \$309, \$589 and \$831	248	(491)	(909)	(1,322)
Amounts reclassified from accumulated other comprehensive loss to interest expense	265	373	875	1,122
Tax benefit included in provision for income taxes	(104)	(144)	(344)	(434)
Total amounts reclassified from accumulated other comprehensive loss	161	229	531	688
Net current-period other comprehensive income (loss)	409	(262)	(378)	(634)
Accumulated other comprehensive loss balance, end of period	\$(397)	\$(798)	\$(397)	\$(798)
Foreign currency translation adjustment:				
Accumulated other comprehensive loss balance, beginning of period	\$(834)	\$(1,390)	\$(806)	\$(868)
Translation adjustments	289	168	261	(354)
Accumulated other comprehensive loss balance, end of period	(545)	(1,222)	(545)	(1,222)
Accumulated other comprehensive loss, end of period	\$(942)	\$(2,020)	\$(942)	\$(2,020)

## 14. Segment Information

As of September 30, 2016, our reportable segments were the General Markets Business Unit ("GMBU"), the Enterprise Customer Business Unit ("ECBU"), and the International Business Unit ("IBU"). Following is a description of each reportable segment:

The GMBU is focused on marketing, sales, delivery and support to all emerging and mid-sized prospects and customers in North America;

The ECBU is focused on marketing, sales, delivery and support to all large and/or strategic prospects and customers in North America; and

The IBU is focused on marketing, sales, delivery and support to all prospects and customers outside of North America.

Our chief operating decision maker is our chief executive officer ("CEO"). The CEO reviews financial information presented on an operating segment basis for the purposes of making certain operating decisions and assessing financial performance. The CEO uses internal financial reports that provide segment revenues and operating income, excluding stock-based compensation expense, amortization expense, depreciation expense, research and development expense and certain corporate sales, marketing, general and administrative expenses. Currently, the CEO believes that the exclusion of these costs allows for a better understanding of the operating performance of the operating units and management of other operating expenses and cash needs. The CEO does not review any segment balance sheet information.

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Blackbaud, Inc.

Notes to consolidated financial statements (continued)

(Unaudited)

Summarized reportable segment financial results, were as follows:

(dollars in thousands)	Three months ended September 30,		Nine months ended September 30,	
	2016	2015	2016	2015
Revenue by segment:				
GMBU	\$97,621	\$78,244	\$279,543	\$224,311
ECBU	74,351	69,326	220,887	205,625
IBU	11,030	11,181	31,926	31,995
Other <sup>(1)</sup>	61	60	154	132
Total revenue	\$183,063	\$158,811	\$532,510	\$462,063
Segment operating income <sup>(2)</sup> :				
GMBU	\$46,540	\$40,718	\$134,408	\$114,719
ECBU	38,696	33,568	113,186	99,522
IBU	1,064	2,431	3,126	5,823
Other <sup>(1)</sup>	(157)	(219)	(109)	(276)
	86,143	76,498	250,611	219,788
Less:				
Corporate unallocated costs <sup>(3)</sup>	(53,236)	(47,975)	(156,013)	(141,162)
Stock-based compensation costs	(8,818)	(6,486)	(25,005)	(17,899)
Amortization expense	(10,549)	(8,069)	(31,817)	(24,286)
Interest expense	(2,641)	(1,816)	(8,037)	(5,375)
Other (expense) income, net	(15)	192	(185)	(1,369)
Income before provision for income taxes	\$10,884	\$12,344	\$29,554	\$29,697

(1) Other includes revenue and the related costs from the sale of solutions and services not directly attributable to a reportable segment.

(2) Segment operating income includes direct, controllable costs related to the sale of solutions and services by the reportable segment.

(3) Corporate unallocated costs include research and development, depreciation expense, and certain corporate sales, marketing, general and administrative expenses.

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Blackbaud, Inc.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our consolidated financial statements and related notes included elsewhere in this Quarterly Report on Form 10-Q. The following discussion and analysis presents financial information denominated in millions of dollars which can lead to differences from rounding when compared to similar information contained in the consolidated financial statements and related notes which are primarily denominated in thousands of dollars.

Executive Summary

Overview

We are the world's leading cloud software company powering social good. Serving the entire social good community—nonprofits, foundations, corporations, education institutions, and individual change agents—we connect and empower organizations to increase their impact through software, services, expertise, and data intelligence. Our portfolio is tailored to the unique needs of vertical markets, with solutions for fundraising and relationship management, digital marketing, advocacy, accounting, payments, analytics, school management, grant management, corporate social responsibility and volunteerism. Serving the industry for more than three decades, we are headquartered in Charleston, South Carolina and have operations in the United States, Australia, Canada, Ireland and the United Kingdom. As of September 30, 2016, we had approximately 35,000 customers.

Our revenue is primarily generated from the following sources: (i) charging for the use of our software solutions in cloud-based and hosted environments; (ii) providing software maintenance and support services; (iii) providing professional services including implementation, training, consulting, analytic, hosting and other services; (iv) providing transaction and payment processing services; and (v) selling perpetual licenses of our software solutions. We have experienced growth in our payment processing services from the continued shift to online giving, further integration of these services to our existing solution portfolio and the sale of these services to new and existing customers.

Our long-term goals include accelerating organic revenue growth, expanding our operating margins and increasing our operating cash flows. During the third quarter of 2016, we continued to execute on the following five growth strategies targeted to achieve those goals and to drive an extended period of quality enhancement, solution and service innovation, and increasing operating efficiency and financial performance:

1. Integrated and Open Solutions in the Cloud

We continue to transition our business to predominantly serve customers through a subscription-based cloud delivery model, enabling lower cost of entry, greater scalability and lower total cost of ownership to our customers. There is a concerted effort underway to optimize our portfolio of solutions and integrate powerful capabilities — such as built in data, analytics, payment processing and tailored user-specific experiences — to bring even greater value and performance to our customers.

During the first and second quarters of 2016, we further expanded certain of our pre-integrated services through the general release of SKY Reporting™, beginning with Raiser's Edge NXT. SKY Reporting provides new business intelligence and reporting tools aimed at seamlessly delivering valuable insights and productivity enhancing capabilities to customers. We also launched a Partner Beta Program for SKY API, a key component of Blackbaud SKY™, which is our new, innovative cloud technology architecture for the global philanthropic community that now powers six of our next generation solutions. SKY API will allow customers, partners, and application developers to extend functionality and integrate with our solutions.

During the third quarter of 2016, we launched our Customer Beta Program for SKY API. We acquired Attentive.ly, a cloud software provider that provides social media capabilities allowing organizations to conduct social listening, identify key influencers and drive engagement through its cloud solution. This acquisition accelerates our ability to deliver these capabilities to our customers by integrating Attentive.ly technology into Blackbaud SKY. We also made several portfolio announcements, ranging from solution integrations, to new capabilities for existing solutions, to new

solution introductions.

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Blackbaud, Inc.

2. Drive Sales Effectiveness

We are making investments to increase the effectiveness of our sales organization, with a focus on enabling our expanding sales teams with the talent, processes, and tools to accelerate our revenue growth and improve effectiveness. Our customer success program separates account management from the sales organization, and is intended to drive customer loyalty and retention.

In the first quarter of 2016, we launched a value added reseller ("VAR") program. During the second and third quarters of 2016, we continued to make investments in our sales, marketing and customer success organizations and improved our market coverage by deploying these resources into key markets like Toronto, where we recently opened a new office. In addition, we are continuing to optimize our go-to-market sales strategies such as offering solutions and services tailored to the needs of customers operating within vertical markets including K-12 private schools, foundations, higher education and healthcare institutions, among others.

3. Expand TAM into Near Adjacencies through Acquisitions and Investments

We will continue to evaluate compelling opportunities to expand our product portfolio and acquire companies, technologies and/or services. We will be guided by our acquisition criteria for considering attractive assets, which expand our total addressable market ("TAM"), provide entry into new and near adjacencies, accelerate our shift to the cloud, accelerate revenue growth, are accretive to margins and present synergistic opportunities.

4. Execute our 3-Year Margin Improvement Plan

In 2014, we implemented a 3-year operating margin improvement plan designed to increase our operating effectiveness and efficiency and improve non-GAAP operating margins 300 to 600 basis points on a constant currency basis as measured against our 2014 baseline of 17.5%, by the time we exit 2017.

5. Streamline Operations

During 2016, we largely completed the installations of best-in-breed back-office solutions that consolidate and standardize our business operations utilizing scalable tools and systems. The operational efficiencies gained from moving to a consistent, modern infrastructure have prepared us for scale and the integration of future acquisitions.

With the substantial completion of this multi-year initiative, our growth strategy is now comprised of the four remaining initiatives: 1. Integrated and Open Solutions in the Cloud; 2. Drive Sales Effectiveness; 3. Expand TAM into Near Adjacencies with Acquisitions and Investments; and 4. Execute our 3-Year Margin Improvement Plan.

We completed our acquisition of Smart Tuition in October 2015. We have included the results of operations of Smart Tuition in our consolidated results of operations from the date of acquisition, which impacts the comparability of our results of operations when comparing the three and nine months ended September 30, 2016 to the same periods in 2015. Therefore, we have noted in the discussion below, to the extent practicable and meaningful, the impact on the comparability of our consolidated results of operations to prior year results due to the inclusion of Smart Tuition. We completed our acquisition of Attentive.ly in July 2016. We have included the results of operations of Attentive.ly in our consolidated results of operations from the date of acquisition; however, Attentive.ly's results are insignificant and are not discussed since they do not have a significant impact on the comparability of our results for any period presented.

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Blackbaud, Inc.

Total revenue

	Three months ended			Nine months ended		
	September 30,			September 30,		
(dollars in millions)	2016 <sup>(1)</sup>	2015	Change	2016 <sup>(1)</sup>	2015	Change
Total revenue	\$183.1	\$158.8	15.3 %	\$532.5	\$462.1	15.2 %

(1) Included in total revenue for the three and nine months ended September 30, 2016 was \$10.3 million and \$27.7 million attributable to solutions historically sold by Smart Tuition.

Excluding the impact of Smart Tuition as discussed above, total revenue increased by \$14.0 million and \$42.8 million during the three and nine months ended September 30, 2016, respectively, when compared to the same periods in 2015. The increases in revenue were primarily driven by growth in subscriptions revenue as our business model continues to shift towards providing predominantly cloud-based subscription solutions. Subscriptions revenue also grew as a result of increases in the number of customers and the volume of transactions for which we process payments. Services revenue contributed modestly to the increases in total revenue during the three and nine months ended September 30, 2016, when compared to the same periods in 2015, primarily due to increases in consulting and training revenue. Maintenance revenue declined for the three and nine months ended September 30, 2016 from the continued migration of our business model toward subscription-based solutions, including our NXT solutions. In the near-term, the transition to subscription-based solutions negatively impacts total revenue growth, as time-based revenue from subscription arrangements is deferred and recognized ratably over the subscription period, whereas on-premises license revenue from arrangements that include perpetual licenses is recognized up-front. In addition, the fluctuation in foreign currency exchange rates, primarily those between the U.S. dollar and Canadian dollar, negatively impacted our total revenue during the three and nine months ended September 30, 2016 by \$1.0 million and \$3.4 million, respectively. Further explanation of this impact is included below under the caption "Foreign Currency Exchange Rates".

Income from operations

	Three months ended			Nine months ended		
	September 30,			September 30,		
(dollars in millions)	2016 <sup>(1)</sup>	2015	Change	2016 <sup>(1)</sup>	2015	Change
Income from operations	\$13.5	\$14.0	(3.1)%	\$37.8	\$36.4	3.7%

(1) Included in income from operations for the three and nine months ended September 30, 2016 was \$1.0 million and \$2.8 million attributable to the inclusion of Smart Tuition.

Excluding the impact of Smart Tuition as discussed above, income from operations decreased \$1.4 million and \$1.5 million during the three and nine months ended September 30, 2016, respectively, when compared to the same periods in 2015. Increases from growth in subscriptions and services revenue as discussed above, improvements in the utilization of consulting services personnel and a reduction in non-billable implementation service hours were offset by increases in stock-based compensation expense of \$2.3 million and \$7.1 million, respectively, amortization of intangible assets from business combinations of \$2.5 million and \$7.5 million, respectively, and investments we are making in our sales and marketing organizations and customer success program. In addition, the fluctuation in foreign currency exchange rates, primarily those between the U.S. dollar and Canadian dollar, negatively impacted our income from operations during the nine months ended September 30, 2016 by \$1.5 million. The impact of the fluctuation in foreign currency exchange rates on our income from operations during the three months ended September 30, 2016 was insignificant. Further explanation of this impact is included below under the caption "Foreign Currency Exchange Rates".

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## Blackbaud, Inc.

## Customer retention

Our subscription contracts are typically for a term of three years at contract inception with one year renewals thereafter. Over time, we anticipate a decrease in maintenance contract renewals as we transition our solution portfolio and maintenance customers from a perpetual license-based model to a cloud-based subscription delivery model. We also anticipate an increase in subscription contract renewals as we continue focusing on innovation, quality and the integration of our subscription solutions which we believe will provide value-adding capabilities to better address our customers' needs. Due primarily to these factors, we believe a recurring revenue customer retention measure that combines subscription and maintenance customer contracts provides an accurate representation of our customers' overall behavior. For the three months ended September 30, 2016, approximately 92% of our customers with recurring subscription or maintenance contracts were retained when compared to the same period in 2015.

## Balance sheet and cash flow

At September 30, 2016, our cash and cash equivalents were \$16.5 million and outstanding borrowings under the 2014 Credit Facility were \$376.7 million. During the nine months ended September 30, 2016, we generated \$100.1 million in cash flow from operations, decreased our net borrowings by \$33.6 million, returned \$17.1 million to stockholders by way of dividends and had cash outlays of \$34.5 million for purchases of property and equipment and capitalized software development costs.

## Lease for New Headquarters Facility

In May 2016, we entered into a lease agreement for a New Headquarters Facility to be built in Charleston, South Carolina. For a detailed discussion of the New Headquarters Facility, see Note 10 of our consolidated financial statements in this report.

## Results of Operations

## Comparison of the three and nine months ended September 30, 2016 and 2015

We acquired Smart Tuition in October 2015. We have included the results of operations of Smart Tuition in our consolidated results of operations from the date of acquisition, which impacts the comparability of our results of operations when comparing the three and nine months ended September 30, 2016 and 2015. We have noted in the discussion below, to the extent meaningful and quantifiable, the impact on the comparability of our consolidated results of operations to prior year results due to the inclusion of Smart Tuition. We acquired Attentive.ly in July 2016. We have included the results of operations of Attentive.ly in our consolidated results of operations from the date of acquisition; however, Attentive.ly's results are insignificant and are not discussed since they do not have a significant impact on the comparability of our results for any period presented.

For the three and nine months ended September 30, 2016, Smart Tuition's total revenue was \$10.3 million and \$27.7 million, respectively, and its income from operations was \$1.0 million and \$2.8 million, respectively. See Note 3 to our consolidated financial statements in this report for a summary of this acquisition.

## Revenue by segment

	Three months ended			Nine months ended				
	September 30,			September 30,				
(dollars in millions)	2016 <sup>(1)</sup>	2015	Change	2016 <sup>(1)</sup>	2015	Change		
GMBU	\$97.6	\$78.2	24.8	%	\$279.5	\$224.3	24.6	%
ECBU	74.4	69.3	7.2	%	220.9	205.6	7.4	%
IBU	11.0	11.2	(1.4)	)%	31.9	32.0	(0.2)	)%
Total revenue <sup>(2)</sup>	\$183.1	\$158.8	15.3	%	\$532.5	\$462.1	15.2	%

<sup>(1)</sup>Included in GMBU revenue and total revenue for the three and nine months ended September 30, 2016 was \$10.3 million and \$27.7 million, respectively, attributable to the inclusion of Smart Tuition.

<sup>(2)</sup>The individual amounts for each year may not sum to total revenue due to rounding.





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Blackbaud, Inc.

## GMBU

(dollars in millions)	Three months ended			Nine months ended			
	September 30,			September 30,			
	2016 <sup>(1)</sup>	2015	Change	2016 <sup>(1)</sup>	2015	Change	
GMBU revenue	\$97.6	\$78.2	24.8	% \$279.5	\$224.3	24.6	%
% of total revenue	53.3	%49.3	%	52.5	%48.5	%	%

(1) Included in GMBU revenue for the three and nine months ended September 30, 2016 was \$10.3 million and \$27.7 million, respectively, attributable to solutions historically sold by Smart Tuition.

Excluding the impact of Smart Tuition as discussed above, GMBU revenue increased by \$9.1 million and \$27.6 million during the three and nine months ended September 30, 2016, respectively, when compared to the same periods in 2015. The increases in GMBU revenue were primarily attributable to growth in subscriptions revenue and, to a lesser extent, services revenue. The growth in subscriptions revenue was primarily due to increases in demand across our portfolio of cloud-based solutions. GMBU subscriptions revenue also benefited from increases in the number of customers and the volume of transactions for which we process payments. GMBU services revenue increased during the three and nine months ended September 30, 2016 when compared to the same periods in 2015 due to increases in consulting and training services related to our cloud-based solutions. The growth in subscriptions and services revenue was partially offset by declines in maintenance and license fee revenue from the continued migration of our business to subscription-based solutions.

## ECBU

(dollars in millions)	Three months ended			Nine months ended			
	September 30,			September 30,			
	2016	2015	Change	2016	2015	Change	
ECBU revenue	\$74.4	\$69.3	7.2	% \$220.9	\$205.6	7.4	%
% of total revenue	40.6	%43.7	%	41.5	%44.5	%	%

The increases in ECBU revenue during the three and nine months ended September 30, 2016, when compared to the same periods in 2015, was primarily attributable to growth in subscriptions revenue, partially offset by decreases in services revenue. The growth in subscriptions resulted primarily from increases in demand for our cloud-based solutions, as well as an increase in the number of customers and the volume of transactions for which we process payments. We expect that the continuing shift in our go-to-market strategy towards cloud-based subscription offerings, which, in general, require less implementation services will negatively impact services revenue growth over time. Also contributing to the increase in ECBU revenue during the three months ended September 30, 2016 was an increase in license fees revenue related to our Blackbaud Enterprise CRM solution, our only remaining perpetual licensed-based offering. License fees revenue from Blackbaud Enterprise CRM can vary from period to period.

## IBU

(dollars in millions)	Three months ended			Nine months ended			
	September 30,			September 30,			
	2016	2015	Change	2016	2015	Change	
IBU revenue	\$11.0	\$11.2	(1.4)	% \$31.9	\$32.0	(0.2)	%
% of total revenue	6.0	%7.0	%	6.0	%6.9	%	%

IBU revenue remained relatively unchanged during the three and nine months ended September 30, 2016, when compared to the same periods in 2015, as increases in subscriptions revenue were offset by reductions in consulting services and maintenance revenue. The increases in IBU subscriptions revenue during the three and nine months ended September 30, 2016 were primarily due to increased demand for our cloud-based solutions as well as increases in the volume of transactions for which we process payments. In the near term, we expect a continued reduction in

IBU revenue related to on-premises Raiser's Edge license fees, consulting services and maintenance as our customers transition to our Raiser's Edge NXT solution.

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Blackbaud, Inc.

Operating results

Subscriptions

(dollars in millions)	Three months ended September 30,			Nine months ended September 30,		
	2016 <sup>(1)</sup>	2015	Change	2016 <sup>(2)</sup>	2015	Change
Subscriptions revenue	\$105.4	\$80.9	30.3 %	\$306.3	\$233.4	31.2 %
Cost of subscriptions	51.9	39.5	31.6 %	153.8	115.1	33.6 %
Subscriptions gross profit <sup>(3)</sup>	\$53.5	\$41.4	29.2 %	\$152.6	\$118.4	28.9 %
Subscriptions gross margin	50.7	%51.2	%	49.8	%50.7	%

(1) Included in subscriptions revenue and cost of subscriptions for the three months ended September 30, 2016 was \$10.3 million and \$6.3 million, respectively, attributable to solutions historically sold by Smart Tuition.

(2) Included in subscriptions revenue and cost of subscriptions for the nine months ended September 30, 2016 was \$27.3 million and \$16.2 million, respectively, attributable to the inclusion of Smart Tuition.

(3) The individual amounts for each year may not sum to subscriptions gross profit due to rounding.

Subscriptions revenue is comprised of revenue from charging for the use of our subscription-based software solutions, which includes providing access to cloud-based solutions and hosting services, access to certain data services and our online subscription training offerings, revenue from payment processing services as well as variable transaction revenue associated with the use of our solutions.

We continue to experience growth in sales of our cloud-based solutions and hosting services as we meet the demand of our customers that increasingly prefer cloud-based subscription offerings, including existing customers that are migrating from on-premises solutions to our cloud-based solutions. In addition, we have experienced growth in our payment processing services from the continued shift to online giving, further integration of these services to our existing solution portfolio and the sale of these services to new and existing customers. Recurring subscriptions contracts are typically for a term of three years at contract inception with one year annual renewals thereafter. We intend to continue focusing on innovation, quality and integration of our subscription solutions which we believe will drive subscriptions revenue growth. We are also investing in our customer success organization to drive customer loyalty, retention, and referrals.

Cost of subscriptions is primarily comprised of compensation costs, third-party contractor expenses, third-party royalty and data expenses, hosting expenses, allocated depreciation, facilities and IT support costs, amortization of intangible assets from business combinations, amortization of software development costs, transaction-based costs related to payments services including remittances of amounts due to third-parties and other costs incurred in providing support and services to our customers.

Excluding the incremental subscriptions revenue from Smart Tuition as discussed above, subscriptions revenue increased by \$14.3 million and \$45.6 million during the three and nine months ended September 30, 2016, respectively, when compared to the same periods in 2015. The increases were primarily due to strong demand across our cloud-based solution portfolio. Subscriptions revenue also grew as a result of increases in the number of customers and the volume of transactions for which we process payments.

The increases in cost of subscriptions during the three and nine months ended September 30, 2016, when compared to the same periods in 2015, were relatively consistent with the increases in revenue. The increases in cost of subscriptions were primarily due to increases in transaction-based costs related to our payments services and those of Smart Tuition of \$5.6 million and \$15.1 million, respectively, increases in amortization of intangible assets from business combinations of \$2.0 million and \$6.2 million, respectively, increases in third-party contractor expenses of \$1.2 million and \$4.5 million, respectively, increases in the cost of third-party technology embedded in certain of our subscription solutions of \$0.9 million and \$3.2 million, respectively, and increases in amortization of software

development costs of \$0.6 million and \$2.7 million, respectively. The increases in amortization of intangible assets from business combinations were primarily due the incremental amortization of intangible assets arising from the acquisition of Smart Tuition. The increases in third-party contract costs and amortization of software development costs were from investments made on innovation, quality and the integration of our cloud-based solutions. The decreases in subscriptions gross margin for the three and nine months ended September 30, 2016, when compared to the same periods in 2015, were primarily the result of a shift in the mix of subscriptions revenue generated from our

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Blackbaud, Inc.

payment processing services and those of Smart Tuition, both of which have historically yielded lower gross margins than our cloud-based solutions. Also contributing to the decreases in subscriptions gross margin was incremental amortization of intangible assets arising from the Smart Tuition acquisition and incremental amortization of software development costs from the investments discussed above.

Maintenance

(dollars in millions)	Three months ended			Nine months ended		
	September 30,			September 30,		
	2016	2015	Change	2016	2015	Change
Maintenance revenue	\$36.4	\$38.2	(4.7 )%	\$111.0	\$115.7	(4.1 )%
Cost of maintenance	5.5	6.7	(17.5 )%	16.5	21.2	(21.9 )%
Maintenance gross profit <sup>(1)</sup>	\$30.9	\$31.5	(2.0 )%	\$94.5	\$94.6	(0.1 )%
Maintenance gross margin	84.8	%82.4	%	85.1	%81.7	%

(1) The individual amounts for each year may not sum to maintenance gross profit due to rounding.

Maintenance revenue is comprised of annual fees derived from maintenance contracts associated with new software licenses and annual renewals of existing maintenance contracts. These contracts provide customers with updates, enhancements and certain upgrades to our software solutions and online, telephone and email support. Maintenance contracts are typically renewed on an annual basis.

Cost of maintenance is primarily comprised of compensation costs, third-party contractor expenses, third-party royalty costs, allocated depreciation, facilities and IT support costs, amortization of intangible assets from business combinations, amortization of software development costs and other costs incurred in providing support and services to our customers.

The decreases in maintenance revenue during the three and nine months ended September 30, 2016 when compared to the same periods in 2015, were primarily related to a reduction in maintenance contracts associated with on-premises Raiser's Edge and Financial Edge solutions as customers migrated to our cloud-based NXT solutions, partially offset by increases in maintenance contracts associated with Blackbaud Enterprise CRM.

The decrease during the three months ended September 30, 2016 was primarily comprised of (i) \$5.3 million of reductions in maintenance from contracts that were migrated to a cloud-based subscription or not renewed and reductions in contracts with existing customers; partially offset by (ii) \$3.2 million of incremental maintenance from new customers associated with new license contracts and increases in contracts with existing customers; and (iii) \$0.3 million of incremental maintenance from contractual inflationary rate adjustments.

The decrease during the nine months ended September 30, 2016 was primarily comprised of (i) \$13.9 million of reductions in maintenance from contracts that were migrated to a cloud-based subscription or not renewed and reductions in contracts with existing customers; partially offset by (ii) \$8.5 million of incremental maintenance from new customers associated with new license contracts and increases in contracts with existing customers; and (iii) \$0.8 million of incremental maintenance from contractual inflationary rate adjustments.

Cost of maintenance decreased during the three and nine months ended September 30, 2016, when compared to the same periods in 2015, primarily as a result of decreases in compensation costs of \$1.2 million and \$4.4 million, respectively, from a shift in support headcount from maintenance towards sales, marketing and customer success expense and a shift in the volume of customer support requests from maintenance towards subscriptions. Also contributing to the decreases in compensation costs were improvements in the efficiency of our customer support center.

Maintenance gross margins increased during the three and nine months ended September 30, 2016 when compared to the same periods in 2015, primarily due to the shifts in compensation costs from maintenance as discussed above, as well as the improvements in the efficiency of our customer support center.

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Blackbaud, Inc.

## Services

(dollars in millions)	Three months ended			Nine months ended			
	September 30,			September 30,			
	2016 <sup>(1)</sup>	2015	Change	2016 <sup>(1)</sup>	2015	Change	
Services revenue	\$36.6	\$35.9	2.0	% \$104.4	\$100.9	3.5	%
Cost of services	24.1	26.2	(8.1)	)% 73.1	79.1	(7.6)	)%
Services gross profit <sup>(2)</sup>	\$12.5	\$9.7	29.3	% \$31.3	\$21.8	43.9	%
Services gross margin	34.2	%26.9	%	30.0	%21.6	%	

(1) Included in services revenue and cost of services for the three and nine months ended September 30, 2016 were insignificant amounts attributable to the inclusion of Smart Tuition.

(2) The individual amounts for each year may not sum to services gross profit due to rounding.

We derive services revenue from consulting, implementation, education, analytic and installation services. Consulting, implementation and installation services involve converting data from a customer's existing system, system configuration, process re-engineering and assistance in file set up. Education services involve customer training activities. Analytic services are comprised of donor prospect research, sales of lists of potential donors, benchmarking studies and data modeling services. These analytic services involve the assessment of current and prospective donor information of the customer and are performed using our proprietary analytical tools. The end product is intended to enable organizations to more effectively target their fundraising activities.

Cost of services is primarily comprised of compensation costs, third-party contractor expenses, classroom rentals, costs incurred in providing customer training, data expense incurred to perform analytic services, allocated depreciation, facilities and IT support costs and amortization of intangible assets from business combinations.

Services revenue increased during the three and nine months ended September 30, 2016, when compared to the same periods in 2015, primarily due to improvements in the utilization of consulting services personnel, a reduction in non-billable implementation service hours as well as an increase in training revenue related to our cloud-based solutions.

We expect that the continuing shift in our go-to-market strategy towards cloud-based subscription offerings, which, in general, require less implementation services and little to no customization services when compared our traditional on-premises perpetual license arrangements, will negatively impact consulting services revenue growth over time. The maturation of our Blackbaud Enterprise CRM solution, our only remaining perpetual licensed-based offering, is lessening the extent of implementation services required.

The decreases in cost of services during the three and nine months ended September 30, 2016, when compared to the same periods in 2015, were primarily due to decreases in compensation costs of \$0.9 million and \$4.1 million, respectively, related to utilization improvements and a reduction in non-billable implementation service hours for our Blackbaud Enterprise CRM solution.

Services gross margin increased during the three and nine months ended September 30, 2016, when compared to the same periods in 2015, primarily due to increased consulting and training revenue coupled with improvements in the utilization of consulting services personnel and a reduction in non-billable implementation hours.

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Blackbaud, Inc.

License fees and other

(dollars in millions)	Three months ended			Nine months ended		
	September 30,			September 30,		
	2016	2015	Change	2016	2015	Change
License fees and other revenue	\$4.6	\$3.8	21.3 %	\$10.7	\$12.0	(10.9 )%
Cost of license fees and other	1.7	1.7	(0.2 )%	3.4	4.1	(17.0 )%
License fees and other gross profit <sup>(1)</sup>	\$2.9	\$2.1	39.5 %	\$7.4	\$8.0	(7.8 )%
License fees and other gross margin	62.2 %	54.0 %		68.6 %	66.3 %	

(1) The individual amounts for each year may not sum to license fees and other gross profit due to rounding.

License fees and other revenue includes revenue from the sale of our software solutions under perpetual license arrangements, reimbursement of travel-related expenses primarily incurred during the performance of services at customer locations, fees from user conferences and third-party software referral fees.

Cost of license fees and other is primarily comprised of third-party software royalties, variable reseller commissions, amortization of software development costs, compensation costs, costs of business forms, costs of user conferences, reimbursable expenses relating to the performance of services at customer locations, allocated depreciation, facilities and IT support costs and amortization of intangible assets from business combinations.

Revenue from license fees and other increased during the three months ended September 30, 2016, when compared to the same period in 2015, primarily as a result of a larger contribution from our Blackbaud Enterprise CRM solution. Our perpetual license transactions for Blackbaud Enterprise CRM can be of substantial value, which can result in period-to-period variations in revenue since the license fee revenue associated with these arrangements is generally recognized up front when the arrangements are entered into.

Revenue from license fees and other decreased during the nine months ended September 30, 2016, when compared to the same period in 2015, primarily as a result of the ongoing transition of our solution portfolio away from a perpetual license-based model toward a cloud-based subscription delivery model.

The decrease in cost of license fees and other during the nine months ended September 30, 2016, when compared to the same period in 2015, was primarily due to less reimbursable expenses relating to the performance of services at customer locations.

License fees and other gross margin increased during the three months ended September 30, 2016, when compared to the same period in 2015, primarily due to the increase in license fees revenue while the associated costs remained unchanged.

License fees and other gross margin increased during the nine months ended September 30, 2016, when compared to the same period in 2015, primarily due to the reduction reimbursable expenses which carry no margin relative to the reduction in license fees revenue.

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Blackbaud, Inc.

Operating expenses

Sales, marketing, and customer success

(dollars in millions)	Three months ended September 30,			Nine months ended September 30,		
	2016	2015	Change	2016	2015	Change
Sales, marketing and customer success expense	\$40.7	\$31.1	30.7 %	\$115.7	\$89.4	29.4 %
% of total revenue	22.2	%19.6	%	21.7	%19.4	%

Sales, marketing, and customer success expense includes compensation costs, travel-related expenses, sales commissions, advertising and marketing materials, public relations costs and allocated depreciation, facilities and IT support costs.

We continue to make investments to drive sales effectiveness, which is a component of our now four-point growth strategy to accelerate revenue growth. The increases in sales, marketing, and customer success expense in dollars and as a percentage of total revenue during the three and nine months ended September 30, 2016, when compared to the same periods in 2015, was primarily due to increases in compensation costs of \$5.9 million and \$15.9 million, respectively, and commissions expense of \$1.1 million and \$4.6 million, respectively. Compensation costs increased primarily due to incremental headcount to support the increase in direct sales, marketing, and customer success efforts of our growing operations. The expansion of our customer success program is targeted to ensure our customers are fully realizing the value of our solutions, which we believe will drive customer loyalty and retention and will also result in increased customer referrals. The increases in commission expense were primarily driven by increases in commissionable revenue during the three and nine months ended September 30, 2016, when compared to the same periods in 2015. The inclusion of Smart Tuition also contributed to the increases in compensation costs and commissions expense.

Research and development

(dollars in millions)	Three months ended September 30,			Nine months ended September 30,		
	2016	2015	Change	2016	2015	Change
Research and development expense	\$22.5	\$20.6	9.5 %	\$68.0	\$62.0	9.6 %
% of total revenue	12.3	%12.9	%	12.8	%13.4	%

Research and development expense includes compensation costs, third-party contractor expenses, software development tools and other expenses related to developing new solutions, upgrading and enhancing existing solutions, and allocated depreciation, facilities and IT support costs.

We continue to make investments to deliver integrated and open solutions in the cloud, which is a component of our now four-point growth strategy to accelerate revenue growth. The increases in research and development expense during the three and nine months ended September 30, 2016, when compared to the same periods in 2015, were primarily due to increases in compensation costs of \$4.4 million and \$10.7 million, respectively. We have added engineering headcount to drive our solution development efforts, and the inclusion of Smart Tuition added to the increases in compensation costs. Also contributing to the increase in research and development expense during the nine months ended September 30, 2016 was an increase in third-party contractor expenses of \$2.1 million, to assist in our solution development efforts. Partially offsetting these increases during the three and nine months ended September 30, 2016 were increases of \$3.0 million and \$8.0 million, respectively, in the amount of software development costs that were capitalized. The increases in amounts capitalized were a result of incurring more qualifying costs associated with development activities that are required to be capitalized under the internal-use software guidance such as those related to development of our next generation NXT and Luminate cloud-based

solutions, as well as development costs associated with the solutions of acquired companies. We expect that the increases in the amount of software development costs capitalized will continue in the near-term as we make investments on innovation, quality and the integration of our solutions which we believe will drive revenue growth. Capitalized software development costs associated with our cloud-based solutions are subsequently amortized to cost of subscriptions revenue over the related asset's estimated useful life, which generally range from three to seven years.

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## Blackbaud, Inc.

Research and development expense decreased as a percentage of total revenue during the three and nine months ended September 30, 2016, when compared to the same periods in 2015, primarily due to the increase in the amount of software development costs capitalized as discussed above.

## General and administrative

(dollars in millions)	Three months ended September 30,			Nine months ended September 30,		
	2016	2015	Change	2016	2015	Change
General and administrative expense	\$22.3	\$18.4	21.0 %	\$62.1	\$53.2	16.6 %
% of total revenue	12.2 %	11.6 %		11.7 %	11.5 %	

General and administrative expense consists primarily of compensation costs for general corporate functions, including senior management, finance, accounting, legal, human resources and corporate development, third-party professional fees, insurance, allocated depreciation, facilities and IT support costs, acquisition-related expenses and other administrative expenses.

The increases in general and administrative expense in dollars and as a percentage of total revenue during the three and nine months ended September 30, 2016, when compared to the same periods in 2015, was primarily due to increases in compensation costs of \$1.0 million and \$5.3 million, respectively. Compensation costs increased primarily due to increases in stock-based compensation expense, employee benefit costs and salaries for the resources needed to support the growth of our business. The increase in stock-based compensation expense was primarily driven by an increase in the grant date fair value of our annual equity awards granted during the three and nine months ended September 30, 2016 when compared to the grant date fair value of our annual equity awards granted during the same periods in 2015. The inclusion of Smart Tuition also contributed to the growth in general and administrative expense during the three and nine months ended September 30, 2016.

## Interest expense

(dollars in millions)	Three months ended September 30,			Nine months ended September 30,		
	2016	2015	Change	2016	2015	Change
Interest expense	\$2.6	\$1.8	45.4 %	\$8.0	\$5.4	49.5 %
% of total revenue	1.4 %	1.1 %		1.5 %	1.2 %	

Interest expense increased during the three and nine months ended September 30, 2016, when compared to the same periods in 2015, primarily due to an increase in our average daily borrowings related to our acquisition of Smart Tuition in October 2015.

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Blackbaud, Inc.

## Deferred revenue

The table below compares the components of deferred revenue from our consolidated balance sheets:

(dollars in millions)	Timing of recognition	September 30, 2016	Change	December 31, 2015
Subscriptions	Over the period billed in advance, generally one year	\$ 143.5	17.1 %	\$ 122.5
Maintenance	Over the period billed in advance, generally one year	80.5	(6.2 )%	85.9
Services	As services are delivered	28.5	0.1 %	28.5
License fees and other	Upon delivery of the solution or service	2.2	463.6 %	0.4
Total deferred revenue <sup>(1)</sup>		254.7	7.3 %	237.3
Less: Long-term portion		6.6	(7.4 )%	7.1
Current portion <sup>(1)</sup>		\$ 248.2	7.8 %	\$ 230.2

(1) The individual amounts for each year may not sum to total deferred revenue or current portion of deferred revenue due to rounding.

To the extent that our customers are billed for our solutions and services in advance of delivery, we record such amounts in deferred revenue. We generally invoice our maintenance and subscription customers in annual cycles 30 days prior to the end of the contract term. Deferred revenue from subscriptions increased during the nine months ended September 30, 2016 primarily due to an increase in subscription sales as well as a seasonal increase subscription contract renewals. Historically, due to the timing of client budget cycles, we have an increase in customer contract renewals in our second quarter as compared to our fourth quarter. The decrease in deferred revenue from maintenance during the nine months ended September 30, 2016 was primarily due to the continuing shift in our go-to-market strategy towards cloud-based subscription offerings, which do not require maintenance contracts. The increase in deferred revenue from license fees and other during the nine months ended September 30, 2016 was primarily due to a seasonal increase in advance registration billings associated with our bbcon user conference, which occurs each year in October. Deferred revenue from services remained relatively unchanged during the nine months ended September 30, 2016.

We have acquired businesses whose net tangible assets include deferred revenue. In accordance with GAAP reporting requirements, we recorded write-downs of deferred revenue from customer arrangements predating the acquisition to fair value, which resulted in lower recorded deferred revenue as of the acquisition date than the actual amounts paid in advance for solutions and services under those customer arrangements. Therefore, our deferred revenue after an acquisition will not reflect the full amount of deferred revenue that would have been reported if the acquired deferred revenue was not written down to fair value. The impact of acquisition-related deferred revenue write-downs largely impacted deferred revenue from subscriptions as of December 31, 2015. Further explanation of this impact is included below under the caption "Non-GAAP financial measures".

## Income tax provision

(dollars in millions)	Three months ended		Nine months ended			
	September 30, 2016	September 30, 2015	September 30, 2016	September 30, 2015	Change	
Income tax provision	\$2.0	\$4.4	(\$56.0)%	\$5.3	\$10.5	(49.1 )%
Effective income tax rate	17.9 %	35.9 %	18.0 %	35.2 %		

The decreases in our effective income tax rates during the three and nine months ended September 30, 2016, when compared to the same periods in 2015, were primarily due to discrete tax benefits from the early adoption of ASU 2016-09 relating to stock-based compensation. Under ASU 2016-09, excess tax benefits generated upon the settlement or exercise of stock awards are no longer recognized as additional paid-in capital but are instead recognized as a reduction to income tax expense. The remaining impacts to our effective income tax rates for these periods were the estimated benefit to our annual 2016 effective tax rate from federal and state research tax credits that were permanently enacted into law in December 2015 and a discrete tax benefit included in the 2016 periods from statute of

limitations expiration, partially offset by the estimated impact to our annual 2016 effective tax rate from Section 162(m) nondeductible compensation.

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Blackbaud, Inc.

In addition to the events that impact our effective income tax rate during both the three and nine months ended September 30, 2016, when compared to the same periods in 2015, the decrease in our effective tax rate during the nine months ended September 30, 2016 was also partially offset by a discrete tax benefit included in the 2015 period from the settlement of an IRS audit.

Our effective income tax rate may fluctuate quarterly as a result of factors, including transactions entered into, changes in the geographic distribution of our earnings or losses, our assessment of certain tax contingencies, valuation allowances, and changes in tax law in jurisdictions where we conduct business.

We have deferred tax assets for federal, state, and international net operating loss carryforwards and state tax credits. The federal and state net operating loss carryforwards are subject to various Internal Revenue Code limitations and applicable state tax laws. A portion of the foreign and state net operating loss carryforwards and a portion of state tax credits have a valuation reserve due to the uncertainty of realizing such carryforwards and credits in the future.

The total amount of unrecognized tax benefit that, if recognized, would favorably affect the effective income tax rate, was \$2.2 million and \$2.3 million at September 30, 2016 and December 31, 2015, respectively. We recognize accrued interest and penalties, if any, related to unrecognized tax benefits as a component of income tax expense.

Non-GAAP financial measures

The operating results analyzed below are presented on a non-GAAP basis. We use non-GAAP revenue, non-GAAP gross profit, non-GAAP gross margin, non-GAAP income from operations, non-GAAP operating margin, non-GAAP net income and non-GAAP diluted earnings per share internally in analyzing our operational performance.

Accordingly, we believe these non-GAAP measures are useful to investors, as a supplement to GAAP measures, in evaluating our ongoing operational performance. While we believe these non-GAAP measures provide useful supplemental information, non-GAAP financial measures should not be considered in isolation from, or as a substitute for, financial information prepared in accordance with GAAP. In addition, these non-GAAP financial measures may not be completely comparable to similarly titled measures of other companies due to potential differences in the exact method of calculation between companies.

We have acquired businesses whose net tangible assets include deferred revenue. In accordance with GAAP reporting requirements, we recorded write-downs of deferred revenue under arrangements predating the acquisition to fair value, which resulted in lower recognized revenue than the contributed purchase price until the related obligations to provide services under such arrangements are fulfilled. Therefore, our GAAP revenues after the acquisitions will not reflect the full amount of revenue that would have been reported if the acquired deferred revenue was not written down to fair value. The non-GAAP measures described below reverse the acquisition-related deferred revenue write-downs so that the full amount of revenue booked by the acquired companies is included, which we believe provides a more accurate representation of a revenue run-rate in a given period and, therefore, will provide more meaningful comparative results in future periods. However, since the deferred revenue acquired in connection with the acquisition of Attentive.ly was highly insignificant and approximates fair value, no deferred revenue write-down was recorded for that acquisition.

The non-GAAP financial measures discussed below exclude the impact of certain transactions because we believe they are not directly related to our operating performance in any particular period, but are for our long-term benefit over multiple periods. We believe that these non-GAAP financial measures reflect our ongoing business in a manner that allows for meaningful period-to-period comparisons and analysis of trends in our business.

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Blackbaud, Inc.

(dollars in millions)	Three months ended			Nine months ended				
	September 30,			September 30,				
	2016	2015	Change	2016	2015	Change		
GAAP Revenue	\$183.1	\$158.8	15.3	%	\$532.5	\$462.1	15.2	%
Non-GAAP adjustments:								
Add: Acquisition-related deferred revenue write-down	—	1.1	(100.0	)%	3.6	7.1	(49.0	)%
Non-GAAP revenue <sup>(1)</sup>	\$183.1	\$159.9	14.5	%	\$536.1	\$469.2	14.3	%
GAAP gross profit	\$99.7	\$84.6	17.9	%	\$285.7	\$242.6	17.7	%
GAAP gross margin	54.5	%53.3	%		53.7	%52.5	%	
Non-GAAP adjustments:								
Add: Acquisition-related deferred revenue write-down	—	1.1						