BLACKBAUD INC
Form 10-Q
November 09, 2006

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

FORM 10-Q

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

For the quarterly period ended September 30, 2006

Or

o **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: 000-23265

BLACKBAUD, INC.

(Exact name of registrant as specified in its charter)

Delaware	
(State or other jurisdiction of incorporation or organization)	**11-2617163** (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 þ NO o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large accelerated filer o Accelerated filer þ Non-accelerated filer o

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

YES o NO þ

The number of shares of the registrant s Common Stock outstanding as of November 3, 2006 was 43,959,744.

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PART I FINANCIAL INFORMATION
Item 1. Financial statements

Blackbaud, Inc.
Consolidated balance sheets
(Unaudited)

(in thousands, except share amounts)	September 30, 2006	December 31, 2005
Assets		
Current assets:		
Cash and cash equivalents	$ 54,261	$ 22,683
Cash, restricted	513	
Accounts receivable, net of allowance of $1,291 and $1,100 at September 30, 2006 and December 31, 2005, respectively	29,816	25,577
Prepaid expenses and other current assets	8,608	8,741
Deferred tax asset, current portion	4,127	7,600
Total current assets	97,325	64,601
Property and equipment, net	8,964	8,700
Deferred tax asset	66,070	71,487
Goodwill	2,408	2,208
Intangible assets, net	8,102	396
Other assets	56	106
Total assets	$ 182,925	$ 147,498
Liabilities and stockholders equity		
Current liabilities:		
Trade accounts payable	$ 4,105	$ 4,683
Accrued expenses and other current liabilities	16,135	15,806
Deferred acquisition costs, current portion	513	
Deferred revenue	71,573	59,459
Total current liabilities	92,326	79,948
Deferred acquisition costs, long-term portion	270	
Long-term deferred revenue	1,564	1,279
Total liabilities	94,160	81,227
Commitments and contingencies (Note 8)		
Stockholders equity:		
Preferred stock; 20,000,000 shares authorized, none outstanding		
	49	48

Common stock, $.001 par value; 180,000,000 shares authorized, 48,687,310 and 47,529,836 shares issued at September 30, 2006 and December 31, 2005, respectively		
Additional paid-in capital	84,597	73,583
Deferred compensation		(6,497)
Treasury stock, at cost; 4,711,144 and 4,267,313 shares at September 30, 2006 and December 31, 2005, respectively	(68,738)	(60,902)
Accumulated other comprehensive income	181	92
Retained earnings	72,676	59,947
Total stockholders equity	88,765	66,271
Total liabilities and stockholders equity	$ 182,925	$ 147,498

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

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Blackbaud, Inc.
Consolidated statements of operations
(Unaudited)

(in thousands, except share and per share amounts)	Three months ended September 30, 2006	Three months ended September 30, 2005	Nine months ended September 30, 2006	Nine months ended September 30, 2005
Revenue				
License fees	$ 7,826	$ 7,291	$ 24,281	$ 22,063
Services	17,014	14,486	46,423	40,070
Maintenance	20,838	18,110	60,079	52,752
Subscriptions	2,839	1,895	7,625	5,028
Other revenue	1,373	1,362	3,991	3,442
Total revenue	49,890	43,144	142,399	123,355
Cost of revenue				
Cost of license fees	514	1,080	1,694	3,166
Cost of services (of which $122, $55, $402 and $229 in the three months ended September 30, 2006 and 2005 and in the nine months ended September 30, 2006 and 2005, respectively, was stock-based compensation expense)	8,641	7,375	24,899	20,988
Cost of maintenance (of which $26, $6, $84 and $28 in the three months ended September 30, 2006 and 2005 and in the nine months ended September 30, 2006 and 2005, respectively, was stock-based compensation expense)	3,272	2,643	9,930	7,947
Cost of subscriptions (of which $4, $0, $13 and $0 in the three months ended September 30, 2006 and 2005 and in the nine months ended September 30, 2006 and 2005, respectively, was stock-based compensation expense)	658	292	1,775	1,126
Cost of other revenue	1,246	1,171	3,751	3,106
Total cost of revenue	14,331	12,561	42,049	36,333
Gross profit	35,559	30,583	100,350	87,022
Operating expenses				
Sales and marketing (of which $193, $38, $633 and $182 in the three months ended September 30, 2006 and 2005 and in the nine months ended September 30, 2006 and 2005, respectively, was stock-based compensation expense)	10,251	8,634	30,072	25,272
Research and development (of which $183, $22, $562 and $119 in the three months ended September 30,	5,742	5,331	17,652	15,758

2006 and 2005 and in the nine months ended September 30, 2006 and 2005, respectively, was stock-based compensation expense)								
General and administrative (of which $1,396, $1,486, $4,206 and $(3,271) in the three months ended September 30, 2006 and 2005 and in the nine months ended September 30, 2006 and 2005, respectively, was stock-based compensation expense (benefit))		5,716		5,891		16,804		8,975
Amortization		190		10		509		10
Total operating expenses		21,899		19,866		65,037		50,015
Income from operations		13,660		10,717		35,313		37,007
Interest income		492		190		865		770
Interest expense		(12)		(12)		(36)		(37)
Other expense, net		(64)		(32)		(196)		(34)
Income before provision for income taxes		14,076		10,863		35,946		37,706
Income tax provision		5,573		3,143		14,043		10,592
Net income	$	8,503	$	7,720	$	21,903	$	27,114
Earnings per share								
Basic	$	0.20	$	0.18	$	0.51	$	0.64
Diluted	$	0.19	$	0.17	$	0.49	$	0.58
Common shares and equivalents outstanding								
Basic weighted average shares		43,438,730		41,961,726		43,182,585		42,628,278
Diluted weighted average shares		44,679,274		45,017,221		44,589,575		46,676,356
Dividends per share	$	0.07	$	0.05	$	0.21	$	0.15

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

Blackbaud, Inc.
Consolidated statements of cash flows
(Unaudited)

(in thousands)	Nine months ended September 30, 2006	2005
Cash flows from operating activities		
Net income	$ 21,903	$ 27,114
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	2,693	2,026
Provision for doubtful accounts and sales returns	1,080	711
Stock-based compensation expense (benefit)	5,900	(2,404)
Amortization of deferred financing fees	36	36
Deferred taxes	8,445	11,613
Excess tax benefit on exercise of stock options		6,033
Changes in assets and liabilities, net of acquisition		
Accounts receivable	(4,871)	(3,427)
Prepaid expenses and other assets	161	(9,963)
Trade accounts payable	(593)	96
Accrued expenses and other current liabilities	178	(1,203)
Deferred revenue	10,428	8,452
Net cash provided by operating activities	45,360	39,084
Cash flows from investing activities		
Purchase of property and equipment	(2,294)	(2,223)
Purchase of net assets of acquired companies	(6,095)	(938)
Net cash used in investing activities	(8,389)	(3,161)
Cash flows from financing activities		
Payments on capital lease obligations		(44)
Proceeds from exercise of stock options	6,044	5,475
Excess tax benefit on exercise of stock options	5,568	
Purchase of treasury stock	(7,836)	(56,229)
Dividend payments to stockholders	(9,174)	(6,380)
Net cash used in financing activities	(5,398)	(57,178)
Effect of exchange rate on cash and cash equivalents	5	(186)
Net increase (decrease) in cash and cash equivalents	31,578	(21,441)
Cash and cash equivalents, beginning of period	22,683	42,144

Cash and cash equivalents, end of period	$ 54,261	$ 20,703

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

Blackbaud, Inc.
Consolidated statements of stockholders equity and comprehensive income
(Unaudited)

(in thousands, except share amounts)

	Comprehensive income	Common stock Shares	Common stock Amount	Additional paid-in capital	Treasury stock	Accumulated other comprehensive income	Deferred compensation	Retained earnings	Total stockholders equity
Balance at December 31, 2004		42,549,056	$ 43	$ 55,292	$	$ 355	$ (1,064)	$ 35,163	$ 89,789
Net income	$ 33,301							33,301	33,301
Payment of dividends								(8,517)	(8,517)
Purchase of 861,076 treasury shares					(60,902)				(60,902)
Exercise of stock options		3,103,790	3	15,554					15,557
Net option exercises		1,389,257	2	(11,909)					(11,907)
Tax impact of exercise of nonqualified stock options				8,589					8,589
Restricted stock grants		487,733		6,621			(6,621)		
Amortization of deferred compensation							315		315
Adjustment of deferred compensation related to options subject to variable accounting				(509)			818		309
Reversal of deferred compensation related to option cancellations				(55)			55		
Translation adjustment, net of tax	(263)					(263)			(263)

Comprehensive income	$ 33,038								
Balance at December 31, 2005		47,529,836	48	73,583	(60,902)	92	(6,497)	59,947	66,271
Net income	$ 21,903							21,903	21,903
Payment of dividends								(9,174)	(9,174)
Purchase of 443,831 treasury shares					(7,797)				(7,797)
Exercise of stock options		1,178,808	1	6,024					6,025
Tax impact of exercise of nonqualified stock options				5,587					5,587
Reclassification due to adoption of new accounting pronouncement				(6,497)			6,497		
Cumulative effect adjustment to assume historical forfeitures				(20)					(20)
Stock-based compensation				5,920					5,920
Restricted stock grants		32,494							
Restricted stock cancellations		(53,828)			(39)				(39)
Translation adjustment, net of tax	89					89			89
Comprehensive income	$ 21,992								
Balance at September 30, 2006		48,687,310	$ 49	$ 84,597	$ (68,738)	$ 181	$	$ 72,676	$ 88,765

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

Blackbaud, Inc.
Condensed notes to consolidated financial statements
September 30, 2006
(Unaudited)

1. Organization

Blackbaud, Inc. (the Company) is the leading global provider of software and related services designed specifically for nonprofit organizations and provides products and services that enable nonprofit organizations to increase donations, reduce fundraising costs, improve communications with constituents, manage their finances and optimize internal operations. As of September 30, 2006 the Company had more than 15,000 active customers distributed across multiple verticals within the nonprofit market including religion, education, foundations, health and human services, arts and cultural, public and societal benefits, environment and animal welfare and international foreign affairs.

2. Summary of significant accounting policies

Unaudited interim financial statements

The interim consolidated financial statements as of September 30, 2006 and for the three and nine months ended September 30, 2006 and 2005, have been prepared by the Company pursuant to the rules and regulations of the 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 operations, consolidated statements of cash flows and consolidated statements of stockholders equity and comprehensive income for the periods presented in accordance with accounting principles generally accepted in the United States (U.S. GAAP). The consolidated balance sheet at December 31, 2005 has been derived from the audited consolidated financial statements at that date. Operating results for the three and nine months ended September 30, 2006 are not necessarily indicative of the results that may be expected for the fiscal year ending December 31, 2006 or any other future period. Certain information and footnote disclosures normally included in annual financial statements prepared in accordance with U.S. 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 the Company s Annual Report on Form 10-K for the year ended December 31, 2005, as revised in the Company s report on Form 8-K filed on November 6, 2006, and other forms filed with the SEC from time to time.

Basis of consolidation

The consolidated financial statements include the accounts of the Company 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 U.S. 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. Areas of the financial statements where estimates may have the most significant effect include the allowance for sales returns and doubtful accounts, lives of tangible and intangible assets, impairment of long-lived assets, realization of deferred tax assets, stock-based compensation, revenue recognition and provision for income taxes. Changes in the facts or circumstances underlying these estimates could result in material changes and actual results could differ from these estimates.

Reclassifications

Certain amounts in the prior year consolidated statement of operations and notes to the consolidated financial statements have been reclassified to conform to the 2006 presentation. Under the current presentation, stock-based compensation expense in the statement of operations is allocated to individual components of operating expenses whereas it was shown as a single component of operating expenses in previous years. See Note 10 of the consolidated financial statements. Additionally, the presentation of segment information has been modified in 2006. See Note 12 of the consolidated financial statements.

Blackbaud, Inc.
Condensed notes to consolidated financial statements (Continued)
September 30, 2006
(Unaudited)

Revenue recognition

The Company s revenue is generated primarily by licensing its software products and providing support, training, consulting, technical, hosting and other professional services for those products. The Company recognizes revenue in accordance with the American Institute of Certified Public Accountants Statement of Position (SOP) 97-2, Software Revenue Recognition, as modified by SOPs 98-4 and 98-9, as well as Technical Practice Aids issued from time to time by the American Institute of Certified Public Accountants, and in accordance with the SEC Staff Accounting Bulletin No. 104, Revenue Recognition in Financial Statements.

Under these pronouncements, the Company recognizes revenue from the sale of software licenses when persuasive evidence of an arrangement exists, the product has been delivered, title and risk of loss have transferred to the customer, the fee is fixed or determinable and collection of the resulting receivable is probable. The Company uses a signed agreement as evidence of an arrangement. Delivery occurs when the product is delivered. The Company s typical license agreement does not include customer acceptance provisions. If acceptance provisions are provided, delivery is deemed to occur upon acceptance. The Company considers the fee to be fixed or determinable unless the fee is subject to refund or adjustment or is not payable within the Company s standard payment terms. The Company considers payment terms greater than 90 days to be beyond its customary payment terms. The Company deems collection probable if the Company expects that the customer will be able to pay amounts under the arrangement as they become due. If the Company determines that collection is not probable, the Company postpones recognition of the revenue until cash collection. The Company sells software licenses with maintenance and, frequently, professional services. The Company allocates revenue to delivered components, normally the license component of the arrangement, using the residual value method based on vendor-specific objective evidence of the fair value of the undelivered elements, which is specific to the Company. Fair value for the maintenance services associated with the Company s software licenses is based upon renewal rates stated in the Company s agreements, which vary according to the level of the maintenance program. Fair value of professional services and other products and services is based on sales of these products and services to other customers when sold on a stand-alone basis.

The Company recognizes revenue from maintenance services ratably over the contract term, which is principally one year. Maintenance revenue also includes the right to unspecified product upgrades on an if-and-when available basis. Subscription revenue includes fees for hosted solutions, data enrichment services and hosted online training programs. Subscription-based revenue and any related set-up fees are recognized ratably over the twelve-month service period of the contracts, as there is no discernible pattern of usage. Hosting revenues are recognized ratably over the thirty-six month period of the hosting contracts.

The Company s services, which include consulting, installation and implementation services, are generally billed based on hourly rates plus reimbursable travel-related expenses. For small service engagements, less than approximately $10,000, the Company frequently contracts for and bills based on a fixed fee plus reimbursable travel-related expenses. The Company recognizes this revenue upon completion of the work performed. When the Company s services include software customization, these services are provided to support customer requests for assistance in creating special reports and other minor enhancements that will assist with efforts to improve operational efficiency and/or to support business process improvements. These services are not essential to the functionality of the Company s software and rarely exceed three months in duration. The Company recognizes revenue as these services are performed. When the Company sells hosting separately from consulting, installation and implementation services, it recognizes that revenue ratably over the service period.

The Company sells training at a fixed rate for each specific class, at a per attendee price, or at a packaged price for several attendees, and revenue is recognized only upon the customer attending and completing training. During the second quarter of 2005, the Company introduced the Blackbaud Training Pass, which permits customers to attend unlimited training over a specified contract period, typically one year, subject to certain restrictions. This revenue is recognized ratably over the stated contract period. The Company recognizes revenue from donor prospect research and data modeling service engagements upon delivery.

To the extent that the Company s customers pay for the above-described services in advance of delivery, the amounts are recorded in deferred revenue.

Blackbaud, Inc.
Condensed notes to consolidated financial statements (Continued)
September 30, 2006
(Unaudited)

Stock-based compensation

Effective January 1, 2006, the Company adopted the provisions of the Financial Accounting Standards Board s (FASB) Statement of Financial Accounting Standards (SFAS) No. 123(R), Share-Based Payment (SFAS No. 123(R)), using the modified prospective application method. SFAS No. 123(R) replaced SFAS No. 123, Accounting for Stock-Based Compensation (SFAS No. 123), and superseded Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB No. 25). Under the fair value recognition provisions of this statement, stock-based compensation cost is measured at the grant date based on the fair value of the award and is recognized as expense over the requisite service period, which is the vesting period. Under the modified prospective application method, prior periods are not revised for comparative purposes. The provisions of SFAS No. 123(R) apply to grants made after the adoption date, awards modified, repurchased or cancelled after the adoption date and existing grants which were partially unvested at that date. Compensation expense for grants outstanding on the date of adoption is recognized over the remaining service period using the grant date fair values and amortization methods determined previously for the SFAS No. 123 pro forma disclosures.

Prior to January 1, 2006, the Company accounted for stock-based compensation under APB No. 25, which provided that no compensation expense should be recorded for stock options or other stock-based awards to employees that are granted with an exercise price that is equal to or greater than the estimated fair value per share of the Company s common stock on the grant date of the award. Certain of the Company s option grants were accounted for as variable awards under the provisions of APB No. 25, which required the Company to record deferred compensation, and recognize compensation expense over the requisite vesting period, for the difference between the exercise price and the fair market value of the stock at each reporting date.

The adoption of SFAS No. 123(R) resulted in the reclassification of $6,497,000 of unamortized deferred compensation that had previously been recorded in accordance with the provisions of APB No. 25, and a nominal cumulative effect adjustment to apply an assumed forfeiture rate to expense previously recorded on options unvested as of the date of adoption, which was recorded in general and administrative expenses.

The adoption of SFAS No. 123(R) had a material impact on our consolidated balance sheets, consolidated statements of operations and consolidated statements of cash flows. See Note 10 of these consolidated financial statements and discussion in the management s discussion and analysis of financial condition and results of operations included in this report for further information regarding our stock-based compensation assumptions and expenses, including pro forma disclosures for prior periods under the provisions of SFAS No. 123. No new stock options were issued in the nine months ended September 30, 2006. The fair value of the Company s options issued in prior periods was determined using the Black-Scholes option-pricing model.

In 2005, the Company began issuing restricted stock under the 2004 Stock Plan. The fair value of the Company s restricted stock awards is determined by using the closing price of the Company s shares, as traded on the NASDAQ exchange, on the date of grant.

Income taxes

Prior to October 13, 1999, the Company was organized as an S corporation under the Internal Revenue Code and, therefore, was not subject to federal income taxes. The Company historically made distributions to its stockholders to cover the stockholders anticipated tax liability. In connection with a recapitalization agreement, the Company converted its U.S. taxable status from an S corporation to a C corporation and, accordingly, since October 14, 1999 has been subject to federal and state income taxes. Upon this conversion and as a result of the recapitalization, the Company recorded a one-time benefit of $107,000,000 to establish a deferred tax asset. This amount was recorded as a direct increase to equity in the statements of stockholders equity. The Company has not recorded a valuation allowance against this item in its deferred tax asset as of September 30, 2006 or December 31, 2005, as the Company believes it will be able to utilize this benefit, which is dependent upon the Company s ability to generate taxable income.

Significant judgment is required in determining the provision for income taxes. The Company records its tax provision at the anticipated tax rates based on estimates of annual pretax income. To the extent that the final results differ from these estimated amounts that were initially recorded, such differences will impact the income tax provision in the period in

Blackbaud, Inc.
Condensed notes to consolidated financial statements (Continued)
September 30, 2006
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which such determination is made and could have an impact on the deferred tax asset. The Company s deferred tax assets and liabilities are recorded at an amount based upon a blended U.S. federal income tax rate of 34.9%. This U.S. federal income tax rate is based on the Company s expectation that the Company s deductible and taxable temporary differences will reverse over a period of years during which, except for 2006 due to stock option exercises and other reductions to taxable income, the Company will have annual taxable income exceeding $10,000,000 per year. If the Company s results of operations fall below that threshold in the future, the Company will adjust its deferred tax assets and liabilities to an amount reflecting a reduced expected U.S. federal income tax rate, consistent with the corresponding expectation of lower taxable income. If such change is determined to be appropriate, it will affect the provision for income taxes during the period that the determination is made.

New accounting pronouncements

In June 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109, Accounting for Income Taxes, (FIN No. 48), effective for fiscal years beginning after December 15, 2006. The interpretation attempts to clarify the accounting for uncertainty in income taxes recognized under current U.S. GAAP and also provides guidance on items such as derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN No. 48 requires evaluation of uncertain tax positions against a more-likely-than-not recognition threshold and requires immediate recognition of positions that exceed that threshold and immediate derecognition when conditions change that move a previously recognized position below that threshold. The Company has not completed the process of evaluating the impact in future periods of adopting FIN No. 48 and is therefore unable to disclose the effect that adoption will have on the Company s financial statements.

In September 2006, the SEC issued Staff Accounting Bulletin No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements (SAB 108). SAB 108 was issued to provide interpretive guidance on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a current year misstatement. The provisions of SAB 108 are effective for fiscal years ending on or after November 15, 2006. Application of this SAB will not alter previous conclusions and is not expected to have a material impact on the Company s financial statements.

In June 2005, the FASB issued SFAS Statement No. 154, Accounting Changes and Error Corrections, a replacement of APB Opinion No. 20, Accounting Changes, and Statem