

PEGASYSTEMS INC
Form 10-Q
August 08, 2013
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

Quarterly Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended June 30, 2013

or

Transition Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the transition period from _____ to _____

Commission File Number: 1-11859

PEGASYSTEMS INC.

(Exact name of Registrant as specified in its charter)

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Massachusetts
*(State or other jurisdiction of
incorporation or organization)*

04-2787865
*(IRS Employer
Identification No.)*

One Rogers Street Cambridge, MA
(Address of principal executive offices)

02142-1209
(Zip Code)

(617) 374-9600

(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 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 Smaller reporting company

(Do not check if smaller reporting company)

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

There were 37,936,265 shares of the Registrant's common stock, \$.01 par value per share, outstanding on July 29, 2013

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Table of Contents**PEGASYSTEMS INC.****UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS**

(in thousands)

	As of June 30, 2013	As of December 31, 2012
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 103,845	\$ 77,525
Marketable securities	69,966	45,460
Total cash, cash equivalents, and marketable securities	173,811	122,985
Trade accounts receivable, net of allowance of \$1,184 and \$963	94,527	134,066
Deferred income taxes	10,152	10,202
Income taxes receivable	7,726	6,261
Other current assets	6,204	5,496
Total current assets	292,420	279,010
Property and equipment, net	29,262	30,827
Long-term deferred income taxes	49,492	49,292
Long-term other assets	1,712	1,680
Intangible assets, net	52,682	58,232
Goodwill	20,451	20,451
Total assets	\$ 446,019	\$ 439,492
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	\$ 2,911	\$ 3,330
Accrued expenses	20,295	15,534
Accrued compensation and related expenses	28,352	40,715
Deferred revenue	98,702	95,546
Total current liabilities	150,260	155,125
Income taxes payable	13,860	13,551
Long-term deferred revenue	20,383	18,719
Other long-term liabilities	17,164	15,618
Total liabilities	201,667	203,013
Stockholders' equity:		
Preferred stock, 1,000 shares authorized; no shares issued and outstanding		
Common stock, 100,000 shares authorized; 37,957 shares and 37,945 shares issued and outstanding	380	379
Additional paid-in capital	137,589	138,576
Retained earnings	105,840	94,349
Accumulated other comprehensive income	543	3,175
Total stockholders' equity	244,352	236,479
Total liabilities and stockholders' equity	\$ 446,019	\$ 439,492

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See notes to unaudited condensed consolidated financial statements.

Table of Contents**PEGASYSTEMS INC.****UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**

(in thousands, except per share amounts)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Revenue:				
Software license	\$ 40,206	\$ 30,999	\$ 83,415	\$ 66,942
Maintenance	37,937	34,495	74,259	65,340
Professional services	39,172	39,562	75,887	83,941
Total revenue	117,315	105,056	233,561	216,223
Cost of revenue:				
Software license	1,576	1,579	3,159	3,178
Maintenance	3,772	3,718	7,507	7,327
Professional services	32,530	34,690	64,865	71,016
Total cost of revenue	37,878	39,987	75,531	81,521
Gross profit	79,437	65,069	158,030	134,702
Operating expenses:				
Selling and marketing	45,346	41,188	84,616	79,583
Research and development	19,761	18,901	39,337	37,905
General and administrative	7,277	7,664	14,073	13,979
Total operating expenses	72,384	67,753	138,026	131,467
Income (loss) from operations	7,053	(2,684)	20,004	3,235
Foreign currency transaction loss	(437)	(841)	(2,327)	(101)
Interest income, net	135	94	253	205
Other (expense) income, net	(94)	263	745	(576)
Income (loss) before provision for income taxes	6,657	(3,168)	18,675	2,763
Provision (benefit) for income taxes	1,954	(901)	4,903	973
Net income (loss)	\$ 4,703	\$ (2,267)	\$ 13,772	\$ 1,790
Earnings (loss) per share:				
Basic and Diluted	\$ 0.12	\$ (0.06)	\$ 0.36	\$ 0.05
Weighted-average number of common shares outstanding				
Basic	37,949	37,865	37,948	37,812
Diluted	38,749	37,865	38,769	38,931
Cash dividends declared per share	\$ 0.03	\$ 0.03	\$ 0.06	\$ 0.06

See notes to unaudited condensed consolidated financial statements.

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

<i>(in thousands)</i>	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Net income (loss)	\$ 4,703	\$ (2,267)	\$ 13,772	\$ 1,790
Other comprehensive loss:				
Unrealized (loss) gain on securities, net of tax	(182)	(25)	(145)	47
Foreign currency translation adjustments	(417)	(1,341)	(2,487)	(67)
Total other comprehensive loss	(599)	(1,366)	(2,632)	(20)
Comprehensive income (loss)	\$ 4,104	\$ (3,633)	\$ 11,140	\$ 1,770

See notes to unaudited condensed consolidated financial statements.

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

	Six Months Ended June 30,	
	2013	2012
Operating activities:		
Net income	\$ 13,772	\$ 1,790
Adjustment to reconcile net income to cash provided by operating activities:		
Excess tax benefits from exercise or vesting of equity awards	(1,718)	(2,225)
Deferred income taxes	(273)	(305)
Depreciation and amortization	9,419	8,976
Stock-based compensation expense	6,713	5,838
Foreign currency transaction loss	2,327	101
Other non-cash items	2,250	2,938
Change in operating assets and liabilities:		
Trade accounts receivable	37,336	6,146
Income taxes receivable and other current assets	(1,031)	(952)
Accounts payable and accrued expenses	(10,051)	(14,153)
Deferred revenue	5,166	2,037
Other long-term assets and liabilities	370	2,336
Cash provided by operating activities	64,280	12,527
Investing activities:		
Purchase of marketable securities	(32,690)	(11,760)
Matured and called marketable securities	8,540	14,207
Investment in property and equipment	(1,972)	(14,949)
Cash used in investing activities	(26,122)	(12,502)
Financing activities:		
Issuance of common stock for share-based compensation plans	801	707
Excess tax benefits from exercise or vesting of equity awards	1,718	2,225
Dividend payments to shareholders	(1,142)	(2,272)
Common stock repurchases for tax withholdings for net settlement of equity awards	(2,780)	(2,851)
Common stock repurchases under share repurchase programs	(7,275)	(2,526)
Cash used in financing activities	(8,678)	(4,717)
Effect of exchange rate on cash and cash equivalents	(3,160)	(834)
Net increase (decrease) in cash and cash equivalents	26,320	(5,526)
Cash and cash equivalents, beginning of period	77,525	60,353
Cash and cash equivalents, end of period	\$ 103,845	\$ 54,827

See notes to unaudited condensed consolidated financial statements.

Table of Contents**PEGASYSTEMS INC.****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****1. ACCOUNTING POLICIES*****Basis of Presentation***

Pegasystems Inc. (together with its subsidiaries, the Company) has prepared the accompanying unaudited condensed consolidated financial statements pursuant to the rules and regulations of the U.S. Securities and Exchange Commission (SEC) regarding interim financial reporting. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America (U.S.) for complete financial statements and should be read in conjunction with the Company's audited financial statements included in the Annual Report on Form 10-K for the year ended December 31, 2012.

In the opinion of management, the Company has prepared the accompanying unaudited condensed consolidated financial statements on the same basis as its audited financial statements, and these financial statements include all adjustments, consisting only of normal recurring adjustments, necessary for a fair presentation of the results of the interim periods presented. The operating results for the interim periods presented are not necessarily indicative of the results expected for the full year 2013.

2. MARKETABLE SECURITIES

(in thousands)

	Amortized Cost	June 30, 2013		Fair Value
		Unrealized Gains	Unrealized Losses	
Municipal bonds	\$ 38,222	34	(43)	\$ 38,213
Corporate bonds	30,282	42	(71)	30,253
Certificates of deposit	1,504		(4)	1,500
	\$ 70,008	76	(118)	\$ 69,966

(in thousands)

	Amortized Cost	December 31, 2012		Fair Value
		Unrealized Gains	Unrealized Losses	
Municipal bonds	\$ 30,488	48	(10)	\$ 30,526
Corporate bonds	14,853	83	(2)	14,934
	\$ 45,341	131	(12)	\$ 45,460

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

As of June 30, 2013, remaining maturities of marketable debt securities ranged from July 2013 to August 2015, with a weighted-average remaining maturity of approximately 13 months.

Table of Contents**3. DERIVATIVE INSTRUMENTS**

The Company uses foreign currency forward contracts (forward contracts) to manage its exposure to changes in foreign currency denominated accounts receivable, intercompany payables and cash primarily held by the U.S. operating company. The Company has been primarily exposed to the fluctuation in the British pound and Euro relative to the U.S. dollar. More recently, the Company has experienced increased levels of exposure to the Australian dollar and India rupee, for which it expects to use forward contracts in future periods.

The forward contracts utilized by the Company are not designated as hedging instruments and as a result, the Company records the fair value of these contracts at the end of each reporting period in its consolidated balance sheet as other current assets for unrealized gains and accrued expenses for unrealized losses, with any fluctuations in the value of these contracts recognized in other (expense) income, net, in its consolidated statement of operations. These forward contracts have 90 day terms or less.

As of June 30, 2013 and December 31, 2012, the Company did not have any forward contracts outstanding.

During the second quarter and first six months of 2013 and 2012, the Company entered into forward contracts with notional values as follows:

Foreign currency (in thousands)	Notional Amount			
	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2013	2012	2013	2012
Euro	16,500	16,200	32,500	27,200
British pound	£ 14,500	£ 11,000	£ 33,500	£ 23,000

During the second quarter and first six months of 2013 and 2012, the total change in the fair value of the Company's forward contracts recorded in other (expense) income, net, was as follows:

(in thousands)	Change in Fair Value in USD			
	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2013	2012	2013	2012
(Loss) gain included in other (expense) income, net	\$ (95)	\$ 244	\$ 743	\$ (596)

Table of Contents**4. FAIR VALUE MEASUREMENTS***Assets Measured at Fair Value on a Recurring Basis*

Fair value is an exit price, representing the amount that would be received from the sale of an asset or paid to transfer a liability in an orderly transaction between market participants based on assumptions that market participants would use in pricing an asset or liability. As a basis for classifying the fair value measurements, a three-tier fair value hierarchy, which classifies the fair value measurements based on the inputs used in measuring fair value, was established as follows: (Level 1) observable inputs such as quoted prices in active markets for identical assets or liabilities; (Level 2) significant other observable inputs that are observable either directly or indirectly; and (Level 3) significant unobservable inputs in which there is little or no market data, which requires the Company to develop its own assumptions. This hierarchy requires the Company to use observable market data, when available, and to minimize the use of unobservable inputs when determining fair value. On a recurring basis, the Company records its marketable securities at fair value.

The Company's investments classified within Level 1 of the fair value hierarchy are valued using quoted market prices. The Company's investments classified within Level 2 of the fair value hierarchy are valued based on matrix pricing compiled by third party pricing vendors, using observable market inputs such as interest rates, yield curves, and credit risk. The Company does not have any investments classified within Level 3 of the fair value hierarchy.

The fair value hierarchy of the Company's cash equivalents and marketable securities at fair value is as follows:

(in thousands)	June 30, 2013	Fair Value Measurements at Reporting Date Using	
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)
Money market funds	\$ 1,638	\$ 1,638	\$
Marketable securities:			
Municipal bonds	\$ 38,213	\$ 15,099	\$ 23,114
Corporate bonds	30,253	30,253	
Certificate of deposits	1,500		1,500
Total marketable securities	\$ 69,966	\$ 45,352	\$ 24,614

(in thousands)	December 31, 2012	Fair Value Measurements at Reporting Date Using	
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)
Money market funds	\$ 2,873	\$ 2,873	\$
Marketable securities:			
Municipal bonds	\$ 30,526	\$ 11,966	\$ 18,560
Corporate bonds	14,934	14,934	

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Total marketable securities	\$	45,460	\$	26,900	\$	18,560
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Assets Measured at Fair Value on a Nonrecurring Basis

Assets recorded at fair value on a nonrecurring basis, such as property and equipment, and intangible assets, are recognized at fair value when they are impaired. During the first six months of 2013 and 2012, the Company did not recognize any impairments on its assets measured at fair value on a nonrecurring basis.

Table of Contents**5. TRADE ACCOUNTS RECEIVABLE, NET OF ALLOWANCE**

(in thousands)	June 30, 2013	December 31, 2012
Trade accounts receivable	\$ 76,411	\$ 112,106
Unbilled trade accounts receivable	19,300	22,923
Total accounts receivable	95,711	135,029
Allowance for sales credit memos	(1,184)	(963)
	\$ 94,527	\$ 134,066

Unbilled trade accounts receivable relate to services earned under time and material arrangements, and maintenance and license arrangements that had not been invoiced as of June 30, 2013 and December 31, 2012, respectively.

6. GOODWILL AND OTHER INTANGIBLE ASSETS

There were no changes in the carrying amount of goodwill during the first six months of 2013.

Intangible assets are recorded at cost and are amortized using the straight-line method over their estimated useful life, which range from four to nine years.

(in thousands)	Cost	Accumulated Amortization	Net Book Value
As of June 30, 2013			
Customer related intangibles	\$ 44,355	\$ (15,607)	\$ 28,748
Technology	43,446	(19,512)	23,934
Other intangibles	2,238	(2,238)	
Total	\$ 90,039	\$ (37,357)	\$ 52,682

(in thousands)	Cost	Accumulated Amortization	Net Book Value
As of December 31, 2012			
Customer related intangibles	\$ 44,355	\$ (13,142)	\$ 31,213
Technology	43,446	(16,431)	27,015
Other intangibles	2,238	(2,234)	4
Total	\$ 90,039	\$ (29,807)	\$ 60,232