PEGASYSTEMS INC
Form 10-Q
November 03, 2009
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

x **Quarterly Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the quarterly period ended September 30, 2009

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)

Massachusetts	**04-2787865**
(State or other jurisdiction of incorporation or organization)	*(IRS Employer Identification No.)*
101 Main Street Cambridge, MA	**02142-1590**
(Address of principal executive offices)	*(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 x 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 x	Non-accelerated filer ¨ (Do not check if smaller reporting company)	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 x

There were 36,678,436 shares of the Registrant s common stock, $.01 par value per share, outstanding on October 26, 2009.

Table of Contents

PEGASYSTEMS INC.

Index to Form 10-Q

Table of Contents

PEGASYSTEMS INC.

UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands)

	As of September 30, 2009	As of December 31, 2008
ASSETS		
Current assets:		
Cash and cash equivalents	$ 56,419	$ 36,087
Marketable securities	141,936	131,142
Total cash, cash equivalents, and marketable securities	198,355	167,229
Trade accounts receivable, net of allowances of $612 and $1,490	27,708	42,801
Short-term license installments	2,951	5,445
Deferred income taxes	4,338	4,351
Income taxes receivable and other current assets	10,729	4,151
Total current assets	244,081	223,977
Long-term license installments, net	3,321	5,413
Property and equipment, net	7,487	5,723
Long-term deferred income taxes and other assets	8,536	8,117
Intangible assets, net	372	479
Goodwill	2,391	2,141
Total assets	$ 266,188	$ 245,850
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 5,333	$ 4,726
Accrued expenses	6,605	9,925
Accrued compensation and related expenses	18,123	18,015
Deferred revenue	27,818	32,231
Total current liabilities	57,879	64,897
Income taxes payable	5,274	5,665
Other long-term liabilities	1,909	2,174
Total liabilities	65,062	72,736
Commitments and contingencies (Note 8)		
Stockholders equity:		
Preferred stock, 1,000 shares authorized; no shares issued and outstanding		
Common stock and paid-in capital, 70,000 shares authorized; 36,673 shares and 35,810 shares issued and outstanding	122,757	118,284
Retained earnings, including accumulated other comprehensive income of $1,816 and $895	78,369	54,830
Total stockholders equity	201,126	173,114

Total liabilities and stockholders equity	$	266,188	$	245,850

See notes to unaudited condensed consolidated financial statements.

Table of Contents

PEGASYSTEMS INC.

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(in thousands, except per share amounts)

	Three Months Ended September 30, 2009	Three Months Ended September 30, 2008	Nine Months Ended September 30, 2009	Nine Months Ended September 30, 2008
Revenue:				
Software license	$ 28,358	$ 17,910	$ 82,045	$ 51,214
Maintenance	12,489	10,045	36,608	29,027
Professional services	23,974	24,743	72,413	72,054
Total revenue	64,821	52,698	191,066	152,295
Cost of revenue:				
Cost of software license	28	30	90	64
Cost of maintenance	1,558	1,454	4,452	4,006
Cost of professional services	22,474	19,072	61,641	56,811
Total cost of revenue	24,060	20,556	66,183	60,881
Gross profit	40,761	32,142	124,883	91,414
Operating expenses:				
Selling and marketing	19,568	15,698	51,663	45,036
Research and development	9,930	7,936	28,198	22,832
General and administrative	3,798	5,067	13,392	15,355
Total operating expenses	33,296	28,701	93,253	83,223
Income from operations	7,465	3,441	31,630	8,191
Installment receivable interest income	74	95	224	248
Other interest income, net	721	1,151	2,404	4,104
Foreign currency transaction gain (loss)	266	(2,010)	2,377	(1,759)
Other income, net		40	17	139
Income before provision for income taxes	8,526	2,717	36,652	10,923
Provision for income taxes	2,525	366	10,768	2,776
Net income	$ 6,001	$ 2,351	$ 25,884	$ 8,147
Earnings per share				
Basic	$ 0.16	$ 0.06	$ 0.72	$ 0.23
Diluted	$ 0.16	$ 0.06	$ 0.68	$ 0.22

Weighted-average number of common shares outstanding								
Basic		36,462		36,419		36,035		36,201
Diluted		38,441		38,212		37,955		37,668
Cash dividends declared per share	$	0.03	$	0.03	$	0.09	$	0.09

See notes to unaudited condensed consolidated financial statements.

Table of Contents

PEGASYSTEMS INC.

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

	Nine Months Ended September 30, 2009	2008
Operating activities:		
Net income	$ 25,884	$ 8,147
Adjustment to reconcile net income to cash provided by operating activities:		
Excess tax benefit from stock options	(14,409)	(2,992)
Deferred income taxes	(901)	(1,054)
Depreciation, amortization and other non-cash items	2,021	1,407
Amortization of investments	2,963	1,261
Stock-based compensation expense	3,523	2,552
Change in operating assets and liabilities:		
Trade accounts receivable	15,093	12,646
License installments	4,586	15,653
Income taxes receivable and other current assets	(801)	(1,302)
Accounts payable and accrued expenses	5,738	915
Deferred revenue	(4,413)	(4,352)
Other long-term assets and liabilities	(445)	(10)
Cash provided by operating activities	38,839	32,871
Investing activities:		
Purchases of marketable securities	(49,851)	(172,626)
Matured and called marketable securities	35,925	80,706
Sale of marketable securities		83,025
Payments for acquisition		(798)
Investment in property and equipment	(3,724)	(2,625)
Cash used in investing activities	(17,650)	(12,318)
Financing activities:		
Issuance of common stock for share-based compensation plans	4,075	6,549
Excess tax benefit from stock options	14,409	2,992
Dividend payments to shareholders	(3,245)	(3,273)
Repurchase of common stock	(17,310)	(11,794)
Cash used in financing activities	(2,071)	(5,526)
Effect of exchange rate on cash and cash equivalents	1,214	(560)
Net increase in cash and cash equivalents	20,332	14,467
Cash and cash equivalents, beginning of period	36,087	26,710
Cash and cash equivalents, end of period	$ 56,419	$ 41,177

Supplemental disclosures:

Income taxes paid	$	6,011	$	4,807
Non-cash financing activity:				
Dividends payable	$	1,101	$	1,095
Repurchases of common stock unsettled	$	34	$	192

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

The Company has prepared the accompanying unaudited condensed consolidated financial statements pursuant to the rules and regulations of the 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, 2008.

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 2009.

In June 2009, the Financial Accounting Standards Board (FASB) issued its final Statement of Financial Accounting Standards (SFAS) No. 168, The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles, a replacement of FASB Statement No. 162 (SFAS 168). SFAS 168 made the FASB Accounting Standards Codification (the Codification) the single source of authoritative U.S. generally accepted accounting principles (U.S. GAAP) used by nongovernmental entities in the preparation of financial statements, except for rules and interpretive releases of the SEC under authority of federal securities laws, which are sources of authoritative guidance for SEC registrants. The Codification is meant to simplify user access to all authoritative accounting guidance by reorganizing U.S. GAAP pronouncements into approximately 90 accounting topics within a consistent structure; its purpose is not to create new accounting and reporting guidance. The Codification supersedes all existing non-SEC accounting and reporting standards and was effective for the Company beginning July 1, 2009. Following SFAS 168, the FASB will not issue new standards in the form of Statements, FASB Staff Positions, or Emerging issues Task Force Abstracts; instead, it will issue Accounting Standards Updates. The FASB will not consider Accounting Standards Updates as authoritative in their own right; these updates will serve only to update the Codification, provide background information about the guidance, and provide the bases for conclusions on the change(s) in the Codification. In the description of Accounting Standards Updates (ASU) that follows, references relate to Codification Topics and Subtopics, and their descriptive titles, as appropriate.

Accounting Standards Not Yet Effective

In September 2009, ASU 2009-13, Revenue Recognition (Topic 605) Multiple-Deliverable Revenue Arrangements (ASU 2009-13) was issued and will change the accounting for multiple-deliverable arrangements to enable vendors to account for products or services (deliverables) separately rather than as a combined unit. Specifically, this guidance amends the criteria in Subtopic 605-25, *Revenue Recognition-Multiple-Element Arrangements,* for separating consideration in multiple-deliverable arrangements. This guidance establishes a selling price hierarchy for determining the selling price of a deliverable, which is based on: (a) vendor-specific objective evidence; (b) third-party evidence; or (c) estimates. This guidance also eliminates the residual method of allocation and requires that arrangement consideration be allocated at the inception of the arrangement to all deliverables using the relative selling price method. In addition, this guidance significantly expands required disclosures related to a vendor s multiple-deliverable revenue arrangements. ASU 2009-13 is effective prospectively for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010 with early adoption permitted. The impact of ASU 2009-13 on the Company s consolidated financial statements will depend on the nature and terms of the Company s revenue arrangements entered into or materially modified after the adoption date.

Table of Contents

2. MARKETABLE SECURITIES

	As of September 30, 2009			
(in thousands)	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
Marketable securities:				
Municipal bonds	$ 127,710	$ 870	$ (3)	$ 128,577
Government sponsored enterprises	6,799	16	(3)	6,812
Corporate bonds	6,548	3	(4)	6,547
Marketable securities	$ 141,057	$ 889	$ (10)	$ 141,936

	As of December 31, 2008			
(in thousands)	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
Marketable securities:				
Municipal bonds	$ 119,843	$ 1,056	$ (3)	$ 120,896
Government sponsored enterprises	5,999	19		6,018
Corporate bonds	4,230	18	(20)	4,228
Marketable securities	$ 130,072	$ 1,093	$ (23)	$ 131,142

3. FAIR VALUE MEASUREMENTS

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. As such, fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or liability. As a basis for considering such assumptions, a three-tier value hierarchy, which prioritizes the inputs used in measuring fair value, was established as follows: (Level 1) observable inputs such as quoted prices in active markets; (Level 2) inputs other than the quoted prices in active markets that are observable either directly or indirectly; and (Level 3) 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 measures certain financial assets and liabilities at fair value, including the Company s marketable securities.

The Company s investments are classified within Level 1 or Level 2 of the fair value hierarchy because they are valued using quoted market prices, or broker dealer quotations and matrix pricing compiled by third party pricing vendors, respectively, which are based on third party pricing sources with reasonable levels of price transparency.

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

Assets Measured at Fair Value on a Recurring Basis

		Fair Value Measurements at Reporting Date Using	
(in thousands)	As of September 30, 2009	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)
Cash equivalents:			
Money market mutual funds	$ 1,661	$ 1,661	$
Total cash equivalents:	$ 1,661	$ 1,661	$
Marketable securities:			
Municipal bonds	$ 128,577	$ 33,742	$ 94,835
Government sponsored enterprises	6,813		6,813
Corporate bonds	6,546	6,546	
Total marketable securities:	$ 141,936	$ 40,288	$ 101,648

Assets Measured at Fair Value on a Nonrecurring Basis

Nonfinancial assets, such as property and equipment, and intangible assets are recognized at fair value when they are deemed to be other-than-temporarily impaired. During the third quarter and first nine months of 2009, we did not recognize any impairment on any assets that are measured at fair value on a nonrecurring basis.

4. TRADE ACCOUNTS RECEIVABLE, NET OF ALLOWANCES

Trade accounts receivable balances, which consist of billed and unbilled amounts, were $27.7 million and $42.8 million as of September 30, 2009 and December 31, 2008, respectively. Trade accounts receivable includes $6.8 million and $6.4 million for services earned under time and material arrangements that had not been invoiced as of September 30, 2009 and December 31, 2008, respectively. The Company s allowance for doubtful accounts was $0.1 million and $0.4 million as of September 30, 2009 and December 31, 2008, respectively. The Company s allowance for sales credit memos was $0.5 million and $1.1 million as of September 30, 2009 and December 31, 2008, respectively.

5. INCOME TAXES RECEIVABLE AND OTHER CURRENT ASSETS

(in thousands)	As of September 30, 2009	As of December 31, 2008
Income taxes receivable	$ 6,280	$ 514
Interest receivables	2,180	2,061
Prepaid expenses	1,640	838

Sales tax receivable		388		511
Reimbursable expenses		241		227
	$	10,729	$	4,151

8

Table of Contents

6. ACCRUED EXPENSES

(in thousands)	As of September 30, 2009	As of December 31, 2008
Accrued other taxes	$ 1,345	$ 2,552
Dividends payable	1,101	1,080
Accrued employee travel	1,026	1,019
Repurchases of common stock unsettled	34	379
Accrued professional services partners fees	1,042	386
Accrued other	2,057	1,954
Accrued income taxes		2,555
	$ 6,605	$ 9,925

7. DEFERRED REVENUE

(in thousands)	As of September 30, 2009	As of December 31, 2008
Maintenance	$ 17,955	$ 15,688
Software license	6,430	12,740
Professional services and other	3,433	3,803
	$ 27,818	$ 32,231

8. COMMITMENTS AND CONTINGENCIES

As of September 30, 2009, there had been no material changes in the Company s purchase commitments for customer support services and operating leases since December 31, 2008.

In addition to the initial purchase consideration for the Company s 2008 acquisition of certain assets of privately held Focus Technology Group, Inc. and a related entity (collectively, Focus), up to approximately $2.1 million of contingent consideration could have become due to the former owners of Focus, based on the achievement of certain performance milestones and sales targets during a period of 30 months from the March 21, 2008 acquisition date. On September 22, 2009, the parties to the original Focus asset purchase agreement entered into an amendment of that agreement (the Amended Agreement). Pursuant to the Amended Agreement, $1.8 million of the original potential contingent consideration was forfeited and $0.3 million of the contingent consideration was earned and is payable in January 2010. The Company recorded the additional $0.3 million consideration as an increase to goodwill.

See Note 12. Income Taxes for discussion on the Company s liability for uncertain tax positions.

Table of Contents

9. COMPREHENSIVE INCOME

Components of comprehensive income include net income and certain transactions that have generally been reported in the consolidated statement of stockholders equity. Other comprehensive income is comprised of currency translation adjustments and available-for-sale securities valuation adjustments. The Company s total comprehensive income is as follows:

(in thousands)	Three Months Ended September 30, 2009	Three Months Ended September 30, 2008	Nine Months Ended September 30, 2009	Nine Months Ended September 30, 2008
Comprehensive income:				
Net income	$ 6,001	$ 2,351	$ 25,884	$ 8,147
Other comprehensive income:				
Unrealized loss on securities, net of tax	(206)	(307)	(186)	(517)
Foreign currency translation adjustments	206	(722)	1,107	(553)
	$ 6,001	$ 1,322	$ 26,805	$ 7,077

10. STOCK-BASED COMPENSATION

For the third quarter and first nine months of 2009 and 2008, stock-based compensation expense was reflected in the Company s unaudited condensed consolidated statements of income as follows:

(in thousands)	Three Months Ended September 30, 2009	Three Months Ended September 30, 2008	Nine Months Ended September 30, 2009	Nine Months Ended September 30, 2008
Stock-based compensation expense:				
Cost of services	$ 250	$ 238	$ 884	$ 703
Operating expenses	715	591	2,639	1,849
Total stock-based compensation before tax	965	829	3,523	2,552
Income tax benefit	(527)	(303)	(1,266)	(829)
Stock-based compensation expense, net of tax benefit	$ 438	$ 526	$ 2,257	$ 1,723

During the first nine months of 2009, the Company issued approximately 1,451,000 shares to its employees under the Company s share-based compensation plans and approximately 18,000 shares to its non-employee Directors.

Table of Contents

Stock Options

The fair value of stock options was estimated on the date of grant using a Black-Scholes option valuation model with the following weighted-average assumptions:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2008	2009	2008
Expected volatility (1)	39%	45%	41%	49%
Expected term in years (2)	5.9	5.9	5.9	5.9
Risk-free interest rate (3)	2.62%	3.18%	2.47%	2.85%
Expected annual dividend yield (4)	0.76%	1.07%	0.91%	1.11%
Weighted-average grant date fair value	$ 11.87	$ 5.86	$ 9.13	$ 4.90

(1) The expected volatility for each grant is determined based on the average of historical weekly price changes of the Company s common stock over a period of time which approximates the expected option term.

(2) The expected option term for each grant is determined based on the historical exercise behavior of employees and post-vesting employment termination behavior.

(3) The risk-free interest rate is based on the yield of zero-coupon U.S. Treasury securities with a term that corresponds to the expected option term at the time of grant.

(4) The expected annual dividend yield is based on the weighted-average of the dividend yield assumption used for options granted during the period. The expected annual dividend yield is based on the expected dividend of $0.12 per share, per year ($0.03 per share, per quarter times 4 quarters) divided by the average stock price.

During the first nine months of 2009, the Company granted approximately 217,000 stock options with a weighted-average exercise price of $23.21. During the first nine months of 2009, option holders net settled stock options representing the right to purchase a total of approximately 2,098,000 shares, of which 1,004,000 shares were issued to the option holders and the balance of the shares were surrendered to the Company to pay for the exercise price and the applicable taxes. As of September 30, 2009, the Company had approximately $2.4 million of unrecognized stock-based compensation expense related to the unvested portion of stock options that is expected to be recognized over a weighted-average period of approximately 2.3 years.

Restricted Stock Units

During the first nine months of 2009, the Company granted approximately 56,000 restricted stock units (RSUs) with a weighted-average grant date fair value of $18.42. As of September 30, 2009, the Company had approximately $1.7 million of unrecognized stock-based compensation expense related to all unvested RSUs that is expected to be recognized over a weighted-average period of 2.0 years.

Table of Contents

11. EARNINGS PER SHARE

Basic earnings per share is computed using the weighted-average number of common shares outstanding during the period. Diluted earnings per share is computed using the weighted-average number of common shares outstanding during the period, plus the dilutive effect of outstanding options, RSUs, and warrants, using the treasury stock method and the average market price of our common stock during the applicable period. Certain shares related to some of our outstanding stock options and RSUs were excluded from the computation of diluted earnings per share because they were anti-dilutive in the periods presented, but could be dilutive in the future.

(in thousands, except per share amounts)	**Three Months Ended September 30, 2009**&n	**Nine Months Ended September 30,**