

PEGASYSTEMS INC  
Form 10-Q  
August 09, 2010  
Table of Contents

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

(Mark One)

Quarterly Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the quarterly period ended June 30, 2010

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)*

**101 Main Street Cambridge, MA**  
*(Address of principal executive offices)*

**(617) 374-9600**

*(Registrant's telephone number including area code)*

**04-2787865**  
*(IRS Employer*

*Identification No.)*

**02142-1590**  
*(Zip 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 approximately 37,120,066 shares of the Registrant's common stock, \$.01 par value per share, outstanding on July 30, 2010.

**Table of Contents**

**PEGASYSTEMS INC.**

**Index to Form 10-Q**

|  | <b>Page</b> |
|--|-------------|
| <b><u>Part I Financial Information</u></b>   |             |
| Item 1. <u>Financial Statements:</u>   |             |
| <u>Unaudited Condensed Consolidated Balance Sheets as of June 30, 2010 and December 31, 2009</u>                           | 3           |
| <u>Unaudited Condensed Consolidated Statements of Operations for the three and six months ended June 30, 2010 and 2009</u> | 4           |
| <u>Unaudited Condensed Consolidated Statements of Cash Flows for the six months ended June 30, 2010 and 2009</u>           | 5           |
| <u>Notes to Unaudited Condensed Consolidated Financial Statements</u>  | 6           |
| Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>                       | 16          |
| Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>  | 28          |
| Item 4. <u>Controls and Procedures</u>   | 29          |
| <b><u>Part II Other Information</u></b>  |             |
| Item 1A. <u>Risk Factors</u>   | 29          |
| Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>   | 29          |
| Item 6. <u>Exhibits</u>  | 30          |
| <u>SIGNATURE</u>   | 31          |

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

(in thousands)

|   | As of<br>June 30,<br>2010 | As of<br>December 31,<br>2009 |
|---|---------------------------|-------------------------------|
| <b>ASSETS</b>   |                           |                               |
| Current assets:   |                           |                               |
| Cash and cash equivalents   | \$ 63,033                 | \$ 63,857                     |
| Marketable securities   | 11,008                    | 138,796                       |
| Total cash, cash equivalents, and marketable securities   | 74,041                    | 202,653                       |
| Trade accounts receivable, net of allowance of \$1,180 and \$649  | 65,910                    | 39,396                        |
| Short-term license installments   | 2,638                     | 2,829                         |
| Deferred income taxes   | 4,514                     | 2,523                         |
| Income taxes receivable and other current assets  | 16,000                    | 8,840                         |
| Total current assets  | 163,103                   | 256,241                       |
| Long-term license installments, net   | 2,394                     | 2,976                         |
| Property and equipment, net   | 11,265                    | 8,931                         |
| Long-term deferred income taxes and other assets  | 2,129                     | 8,710                         |
| Intangible assets, net  | 88,728                    | 336                           |
| Goodwill  | 50,976                    | 2,391                         |
| Total assets  | \$ 318,595                | \$ 279,585                    |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY</b>  |                           |                               |
| Current liabilities:  |                           |                               |
| Accounts payable  | \$ 5,483                  | \$ 4,791                      |
| Accrued expenses  | 23,338                    | 6,748                         |
| Accrued compensation and related expenses   | 18,839                    | 23,280                        |
| Deferred revenue  | 53,761                    | 32,870                        |
| Total current liabilities   | 101,421                   | 67,689                        |
| Income taxes payable  | 6,778                     | 4,828                         |
| Other long-term liabilities   | 7,462                     | 1,849                         |
| Total liabilities   | 115,661                   | 74,366                        |
| Commitments and contingencies (Note 9)  |                           |                               |
| Stockholders' equity:   |                           |                               |
| Preferred stock, 1,000 shares authorized; no shares issued and outstanding  |                           |                               |
| Common stock and additional paid-in capital, 70,000 shares authorized; 37,113 shares and 36,818 shares issued and outstanding | 128,022                   | 121,757                       |
| Retained earnings and accumulated other comprehensive (loss) income of \$(302) and \$1,686                                    | 74,912                    | 83,462                        |
| Total stockholders' equity  | 202,934                   | 205,219                       |
| Total liabilities and stockholders' equity  | \$ 318,595                | \$ 279,585                    |

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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<br>June 30, |                  | Six Months Ended<br>June 30, |                  |
|---|--------------------------------|------------------|------------------------------|------------------|
|   | 2010                           | 2009             | 2010                         | 2009             |
| <b>Revenue:</b>   |                                |                  |                              |                  |
| Software license  | \$ 28,200                      | \$ 25,651        | \$ 58,543                    | \$ 53,687        |
| Maintenance   | 20,388                         | 12,171           | 35,474                       | 24,119           |
| Professional services                                     | 33,658                         | 26,056           | 63,313                       | 48,439           |
| <b>Total revenue</b>                                      | <b>82,246</b>                  | <b>63,878</b>    | <b>157,330</b>               | <b>126,245</b>   |
| <b>Cost of revenue:</b>                                   |                                |                  |                              |                  |
| Cost of software license                                  | 1,109                          | 31               | 1,140                        | 62               |
| Cost of maintenance                                       | 2,715                          | 1,457            | 4,652                        | 2,894            |
| Cost of professional services                             | 27,436                         | 20,104           | 51,904                       | 39,167           |
| <b>Total cost of revenue</b>                              | <b>31,260</b>                  | <b>21,592</b>    | <b>57,696</b>                | <b>42,123</b>    |
| <b>Gross profit</b>                                       | <b>50,986</b>                  | <b>42,286</b>    | <b>99,634</b>                | <b>84,122</b>    |
| <b>Operating expenses:</b>                                |                                |                  |                              |                  |
| Selling and marketing                                     | 29,896                         | 16,659           | 51,789                       | 32,095           |
| Research and development                                  | 14,010                         | 9,149            | 25,636                       | 18,268           |
| General and administrative                                | 6,745                          | 4,648            | 11,804                       | 9,594            |
| Acquisition-related costs                                 | 3,395                          | -                | 4,903                        | -                |
| Restructuring costs                                       | 6,080                          | -                | 6,080                        | -                |
| <b>Total operating expenses</b>                           | <b>60,126</b>                  | <b>30,456</b>    | <b>100,212</b>               | <b>59,957</b>    |
| (Loss) income from operations                             | (9,140)                        | 11,830           | (578)                        | 24,165           |
| Foreign currency transaction (loss) gain                  | (2,542)                        | 2,923            | (5,616)                      | 2,111            |
| Interest income, net                                      | 119                            | 881              | 632                          | 1,683            |
| Installment receivable interest income                    | 52                             | 75               | 104                          | 150              |
| Other income, net   | 1                              | 7                | 242                          | 17               |
| (Loss) income before (benefit) provision for income taxes | (11,510)                       | 15,716           | (5,216)                      | 28,126           |
| (Benefit) provision for income taxes                      | (3,322)                        | 4,475            | (879)                        | 8,243            |
| <b>Net (loss) income</b>                                  | <b>\$ (8,188)</b>              | <b>\$ 11,241</b> | <b>\$ (4,337)</b>            | <b>\$ 19,883</b> |
| <b>Net (loss) earnings per share:</b>                     |                                |                  |                              |                  |
| Basic   | \$ (0.22)                      | \$ 0.31          | \$ (0.12)                    | \$ 0.56          |
| Diluted   | \$ (0.22)                      | \$ 0.30          | \$ (0.12)                    | \$ 0.53          |

Weighted-average number of common shares outstanding

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|                                   |         |         |         |         |
|-----------------------------------|---------|---------|---------|---------|
| Basic                             | 37,054  | 35,965  | 36,966  | 35,818  |
| Diluted                           | 37,054  | 37,995  | 36,966  | 37,708  |
| 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 CASH FLOWS**

(in thousands)

|   | Six Months Ended<br>June 30, |                 |
|---|------------------------------|-----------------|
|   | 2010                         | 2009            |
| <b>Operating activities:</b>  |                              |                 |
| Net (loss) income   | \$ (4,337)                   | \$ 19,883       |
| Adjustment to reconcile net (loss) income to cash (used in) provided by operating activities: |                              |                 |
| Excess tax benefits from exercise or vesting of equity awards                                 | (5,529)                      | (10,068)        |
| Deferred income taxes   | (321)                        | (783)           |
| Depreciation, amortization and other non-cash items   | 3,727                        | 1,259           |
| Amortization of investments and realized gain on sale of investments                          | 666                          | 1,918           |
| Stock-based compensation expense  | 3,632                        | 2,558           |
| Foreign currency transaction loss   | 4,011                        | -               |
| Change in operating assets and liabilities:   |                              |                 |
| Trade accounts receivable   | (12,529)                     | 10,424          |
| License installments  | 773                          | 3,188           |
| Income taxes receivable and other current assets  | 395                          | (283)           |
| Accounts payable and accrued expenses   | 2,970                        | (2,697)         |
| Deferred revenue  | 6,025                        | 3,883           |
| Other long-term assets and liabilities  | (5,801)                      | 150             |
| <b>Cash (used in) provided by operating activities</b>  | <b>(6,318)</b>               | <b>29,432</b>   |
| <b>Investing activities:</b>  |                              |                 |
| Purchases of marketable securities  | (61,156)                     | (29,535)        |
| Matured and called marketable securities  | 26,280                       | 18,535          |
| Sale of marketable securities   | 162,242                      | -               |
| Payments for 2010 acquisition, net of cash acquired   | (108,991)                    | -               |
| Payments for 2008 acquisition   | (250)                        | -               |
| Investment in property and equipment  | (3,497)                      | (1,789)         |
| <b>Cash provided by (used in) investing activities</b>  | <b>14,628</b>                | <b>(12,789)</b> |
| <b>Financing activities:</b>  |                              |                 |
| Issuance of common stock for share-based compensation plans                                   | 1,198                        | 3,042           |
| Excess tax benefits from exercise or vesting of equity awards                                 | 5,529                        | 10,068          |
| Dividend payments to shareholders   | (2,216)                      | (2,155)         |
| Common stock repurchases for tax withholdings for net settlement of equity awards             | (4,212)                      | (5,606)         |
| Repurchase of common stock  | (3,330)                      | (9,202)         |
| <b>Cash used in financing activities</b>  | <b>(3,031)</b>               | <b>(3,853)</b>  |
| <b>Effect of exchange rate on cash and cash equivalents</b>                                   | <b>(6,103)</b>               | <b>919</b>      |
| <b>Net (decrease) increase in cash and cash equivalents</b>                                   | <b>(824)</b>                 | <b>13,709</b>   |
| <b>Cash and cash equivalents, beginning of period</b>   | <b>63,857</b>                | <b>36,087</b>   |



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|  |    |        |    |        |
|--|----|--------|----|--------|
| Cash and cash equivalents, end of period | \$ | 63,033 | \$ | 49,796 |
|--|----|--------|----|--------|

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, 2009.

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 2010.

***Correction of Statement of Cash Flow***

After the issuance of our March 31, 2010 interim financial statements, management identified an error in the presentation of currency transaction losses on foreign currency denominated cash and cash equivalents within the statement of cash flows. These losses should have been presented as a reconciling item within cash flows from operating activities and included within the *Effect of exchange rate on cash and cash equivalents* in the statement of cash flows. The impact of the applicable line items within the condensed consolidated statement of cash flows for the three months ended March 31, 2010 is as follows:

|  | Three Months Ended |              |
|--|--------------------|--------------|
|  | March 31, 2010     |              |
| <i>(in thousands)</i>                                | As Reported        | As Corrected |
| Foreign currency transaction loss                    | \$ -               | \$ 2,263     |
| Cash provided by operations                          | \$ 4,824           | \$ 7,087     |
| Effect of exchange rate on cash and cash equivalents | \$ (487)           | \$ (2,750)   |

The effect of the presentation error has no impact on the reported cash and cash equivalents, total changes in cash flows for the period, the condensed consolidated statement of operations or condensed consolidated balance sheet. This matter did not have a material impact on the 2009, 2008, or 2007 consolidated financial statements, or any interim period within those years.

As the Company has concluded that these adjustments are immaterial to the March 31, 2010 interim financial statements, these adjustments will be prospectively reflected in applicable condensed consolidated statement of cash flows reported in the Company's Form 10-Q for the quarter ended March 31, 2011.

***Acquisition-related costs***

Acquisition-related costs are expensed as incurred and include costs to effect an impending or completed acquisition and direct and incremental costs associated with an acquisition. During the first six months of 2010, acquisition-related costs were primarily advisory fees, legal, tax consulting and valuation fees associated with the Company's acquisition of Chordiant. See Note 5 Acquisition, Goodwill and Intangibles for further discussion of the acquisition.

***Restructuring costs***

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Restructuring costs include severance and related benefit costs for the reduction of personnel during the second quarter of 2010 related to the Chordiant acquisition. See Note 8 Accrued Restructuring Costs for further detail.

**Table of Contents****2. 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 based on assumptions that market participants would use in pricing an asset or liability. As a basis for classifying 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 for identical assets or liabilities; (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 its marketable securities and cash equivalents at fair value and classifies them as follows:

|                                       |                      | Fair Value Measurements at                                     |                             |
|---------------------------------------|----------------------|--|-----------------------------|
|                                       |                      | Reporting Date Using   | Significant Other           |
|                                       |                      | Quoted Prices in Active Markets for Identical Assets (Level 1) | Observable Inputs (Level 2) |
| <i>(in thousands)</i>                 | <b>June 30, 2010</b> |  |                             |
| Cash equivalents                      | \$ 7,564             | \$ 7,564   | \$                          |
| Marketable securities:                |                      |  |                             |
| Municipal bonds                       | \$ 2,152             | \$ 2,152   | \$                          |
| Government sponsored enterprise bonds | 7,793                | 7,793  |                             |
| Corporate bonds                       | 1,063                | 1,063  |                             |
| Total marketable securities           | \$ 11,008            | \$ 11,008  | \$                          |

|                                       |                          | Fair Value Measurements at                                     |                             |
|---------------------------------------|--------------------------|--|-----------------------------|
|                                       |                          | Reporting Date Using   | Significant Other           |
|                                       |                          | Quoted Prices in Active Markets for Identical Assets (Level 1) | Observable Inputs (Level 2) |
| <i>(in thousands)</i>                 | <b>December 31, 2009</b> |  |                             |
| Cash equivalents                      | \$ 9,880                 | \$ 9,880   | \$                          |
| Marketable securities:                |                          |  |                             |
| Municipal bonds                       | \$ 112,723               | \$ 27,152  | \$ 85,571                   |
| Government sponsored enterprise bonds | 19,560                   |  | 19,560                      |
| Corporate bonds                       | 6,513                    | 6,513  |                             |
| Total marketable securities           | \$ 138,796               | \$ 33,665  | \$ 105,131                  |

**Table of Contents****3. TRADE ACCOUNTS RECEIVABLE, NET OF ALLOWANCES**

Unbilled trade accounts receivable relate to services earned under time and material arrangements, maintenance and license arrangements that had not been invoiced as of June 30, 2010 and December 31, 2009, respectively.

| <i>(in thousands)</i>            | As of<br>June 30,<br>2010 | As of<br>December 31,<br>2009 |
|----------------------------------|---------------------------|-------------------------------|
| Trade accounts receivable        | \$ 50,613                 | \$ 32,042                     |
| Unbilled accounts receivable     | 16,477                    | 8,003                         |
| <b>Total accounts receivable</b> | <b>67,090</b>             | <b>40,045</b>                 |
| Allowance for sales credit memos | (998)                     | (541)                         |
| Allowance for doubtful accounts  | (182)                     | (108)                         |
| <b>Total allowances</b>          | <b>(1,180)</b>            | <b>(649)</b>                  |
|                                  | <b>\$ 65,910</b>          | <b>\$ 39,396</b>              |

**4. INCOME TAXES RECEIVABLE AND OTHER CURRENT ASSETS**

| <i>(in thousands)</i> | As of<br>June 30,<br>2010 | As of<br>December 31,<br>2009 |
|-----------------------|---------------------------|-------------------------------|
| Income tax receivable | \$ 11,697                 | \$ 5,046                      |
| Interest receivable   | 59                        | 1,664                         |
| Prepaid expenses      | 2,306                     | 1,092                         |
| Reimbursable expenses | 791                       | 424                           |
| Sales tax receivable  | 1,147                     | 614                           |
|                       | <b>\$ 16,000</b>          | <b>\$ 8,840</b>               |

**5. ACQUISITION, GOODWILL, AND INTANGIBLES*****Chordiant Acquisition***

On April 21, 2010, the Company acquired all of the outstanding shares of common stock of Chordiant, a leading provider of customer relationship management ( CRM ) software and services with a focus on improving customer experiences through decision technology. The aggregate purchase price for Chordiant was approximately \$160.3 million consisting of \$156.8 million in cash and stock options with a fair value of \$3.5 million. The Company issued approximately 241,000 stock options as replacement of outstanding Chordiant stock options at the date of the closing. The majority of the fair value of these stock options was recorded as purchase price based on the portion of the awards related to pre-combination services. The compensation expense associated with the portion of the replacement awards related to post-combination services totaled \$0.2 million and will be recognized as compensation expense over the remaining service period. As of June 30, 2010, the Company incurred direct incremental expenses associated with the transaction of \$4.9 million.

The Company believes the acquisition will expand its global customer base and provide complementary solutions. Chordiant clients will be able to incorporate Pegasystems process automation to enhance their experience in their existing call center and marketing solutions. Pegasystems clients will benefit from Chordiant s decision management solutions and extensive CRM assets. In addition, the Company believes the combination of the two companies will expand the partner network and provide incremental business opportunity growth.



**Table of Contents**

The operations of Chordiant are included in our operating results from the date of acquisition. For the three and six months ended June 30, 2010, \$7.8 million of revenue was directly attributable to Chordiant operations. Due to the rapid integration of the sales force and operations of Chordiant, it will become increasingly difficult to separately identify revenue from arrangements attributable to Chordiant.

The valuation of the acquired intangible assets and assumed liabilities is preliminary. The Company is currently in the process of investigating the facts and circumstances existing as of the acquisition date in order to finalize its valuation and establish the related tax basis. As a result of the preliminary purchase price allocation, the Company recognized approximately \$48.6 million of goodwill, which is primarily due to the expected synergies of the combined entities and the workforce in place. The goodwill created by the transaction is nondeductible for tax purposes. A summary of the preliminary purchase price allocation for the acquisition of Chordiant is as follows:

*(in thousands)*

|   |        |             |
|---|--------|-------------|
| Total purchase consideration:                 |        |             |
| Cash  | \$     | 156,832     |
| Stock options                                 |        | 3,519       |
| <br>Total purchase consideration              | <br>\$ | <br>160,351 |
| <br>Allocation of the purchase consideration: |        |             |
| Cash  | \$     | 47,604      |
| Accounts receivable, net of allowances        |        | 14,231      |
| Other assets                                  |        | 2,661       |
| Property, plant, and equipment                |        | 753         |
| Identifiable intangible assets                |        | 90,400      |
| Goodwill                                      |        | 48,585      |
| Accounts payable                              |        | (5,303)     |
| Accrued liabilities                           |        | (10,478)    |
| Deferred revenue                              |        | (17,863)    |
| Deferred tax liabilities, net                 |        | (6,665)     |
| Other long-term liabilities                   |        | (3,574)     |
| <br>Net assets acquired                       | <br>\$ | <br>160,351 |

The valuation of the assumed deferred maintenance revenue liability was based on the Company's contractual commitment to provide post-contract customer support to Chordiant customers. The fair value of this assumed liability was based on the cost plus a reasonable margin to fulfill these service obligations. The majority of the deferred revenue is expected to be recognized in the next 12 months. The valuation of the acquired intangible assets is inherently subjective and relies on significant unobservable inputs. The valuation assumptions take into consideration the Company's estimates of contract renewal, technology attrition and revenue growth projections. The preliminary allocations of the purchase price consideration to tangible and intangible assets acquired were based on our estimates and assumptions that are still subject to change.

The preliminary values for specifically identifiable intangible assets, by major asset class, are as follows:

|                                    |           | <b>Weighted-average<br/>amortization<br/>period</b> |
|------------------------------------|-----------|---|
| <i>(in thousands)</i>              |           | <b>(in years)</b>                                   |
| Customer related intangible assets | \$ 45,729 | 9   |
| Technology                         | 44,421    | 9   |
| Trade name                         | 250       | 1   |

\$ 90,400

8.4

9



**Table of Contents****Pro forma Information**

The following unaudited pro forma financial information presents the combined results of operations of the Company and Chordiant as if the acquisition had occurred on January 1, 2010 and 2009, respectively, after giving effect to certain pro forma adjustments. The pro forma adjustments reflected herein include only those adjustments that are directly attributable to the Chordiant acquisition, factually determinable, and expected to have a continuing impact on the Company. These pro forma adjustments include a reduction of historical Chordiant revenue for fair value adjustments related to acquired deferred revenue and deferred costs, a net increase in amortization expense to eliminate historical amortization of Chordiant intangible assets and to record amortization expense for the \$90.4 million of acquired identifiable intangibles, and a decrease in interest income as a result of the cash paid for the acquisition. The unaudited pro forma financial information does not reflect any adjustments for anticipated synergies resulting from the acquisition and is not necessarily indicative of the operating results that would have actually occurred had the transaction been consummated as of January 1, 2010 and 2009, respectively. The preliminary allocations of the purchase price consideration to tangible and intangible assets acquired and liabilities assumed herein were based upon preliminary valuations and our estimates and assumptions are still subject to change.

|                                     | Pro Forma<br>Three Months Ended<br>June 30, |           | Pro Forma<br>Six Months Ended<br>June 30, |            |
|-------------------------------------|---|-----------|---|------------|
|                                     | 2010  | 2009      | 2010                                      | 2009       |
| Revenue                             | \$ 85,524                                   | \$ 80,545 | \$ 234,087                                | \$ 156,704 |
| Net (loss) income                   | (16,858)                                    | 7,184     | (11,632)                                  | 8,256      |
| Net (loss) income per basic share   | \$ (0.45)                                   | \$ 0.20   | \$ (0.31)                                 | \$ 0.23    |
| Net (loss) income per diluted share | \$ (0.45)                                   | \$ 0.19   | \$ (0.31)                                 | \$ 0.22    |

**Goodwill and Intangibles**

The Company operates in one operating segment. The following table presents the change in the carrying amount of goodwill:

|                                     | As of<br>June 30,<br>2010 |
|-------------------------------------|---------------------------|
| (in thousands)                      |                           |
| Beginning balance as of January 1,  | \$ 2,391                  |
| Goodwill acquired during the period | 48,585                    |
|                                     | \$ 50,976                 |

Amortized intangible assets consist of the following:

| (in thousands)             | Cost      | Accumulated<br>Amortization | Net Book<br>Value |
|----------------------------|-----------|-----------------------------|-------------------|
| <b>As of June 30, 2010</b> |           |                             |                   |
| Customer relationships     | \$ 45,729 | \$ (847)                    | \$ 44,882         |
| Technology                 | 44,421    | (1,048)                     | 43,373            |
| Trade name                 | 250       | (42)                        | 208               |
| Technology designs         | 490       | (279)                       | 211               |
| Non-compete agreements     | 100       | (46)                        | 54                |
| Intellectual property      | 1,400     | (1,400)                     |                   |

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|       |           |            |           |
|-------|-----------|------------|-----------|
| Total | \$ 92,390 | \$ (3,662) | \$ 88,728 |
|-------|-----------|------------|-----------|

**As of December 31, 2009**

|                        |                 |                   |               |
|------------------------|-----------------|-------------------|---------------|
| Technology designs     | \$ 490          | \$ (218)          | \$ 272        |
| Non-compete agreements | 100             | (36)              | 64            |
| Intellectual property  | 1,400           | (1,400)           |               |
| <b>Total</b>           | <b>\$ 1,990</b> | <b>\$ (1,654)</b> | <b>\$ 336</b> |

**Table of Contents**

Amortization expense for all of the acquired intangibles was approximately \$2.0 million during both the second quarter and first six months of 2010, of which approximately \$1.1 million was included in cost of software licenses and approximately \$0.9 million was included in operating expenses. Amortization expense was de minimis in 2009.

| <i>(in thousands)</i> | <b>Future estimated<br/>amortization<br/>expense</b> |
|-----------------------|--|
| <b>As of June 30,</b> |  |
| Remainder of 2010     | \$ 5,810   |
| 2011                  | 11,453   |
| 2012                  | 11,370   |
| 2013                  | 11,370   |
| 2014                  | 9,746  |
| 2015 and thereafter   | 38,714   |
|                       | <b>\$ 88,463</b>                                     |

**6. ACCRUED EXPENSES**

| <i>(in thousands)</i>                           | <b>As of<br/>June 30,<br/>2010</b> | <b>As of<br/>December 31,<br/>2009</b> |
|---|------------------------------------|--|
| Accrued restructuring                           | \$ 3,904                           | \$ -                                   |
| Accrued professional services partners fees     | 2,491                              | 1,055                                  |
| Accrued other taxes                             | 2,080                              | 1,289                                  |
| Dividends payable                               | 1,114                              | 1,105                                  |
| Accrued employee reimbursable expenses          | 1,849                              | 799                                    |
| Accrued acquisition-related costs               | 451                                | -                                      |
| Accrued self-insurance health and dental claims | 1,549                              | -                                      |
| Accrued litigation judgment                     | 1,426                              | -                                      |
| Accrued professional fees                       | 1,308                              | 389                                    |
| Accrued short-term deferred rent                | 1,027                              | 422                                    |
| Repurchases of common stock unsettled           | 100                                | 136                                    |
| Accrued other                                   | 6,039                              | 1,553                                  |
|   | <b>\$ 23,338</b>                   | <b>\$ 6,748</b>                        |

**7. DEFERRED REVENUE**

| <i>(in thousands)</i>           | <b>As of<br/>June 30,<br/>2010</b> | <b>As of<br/>December 31,<br/>2009</b> |
|---------------------------------|------------------------------------|--|
| Software license                | \$ 5,442                           | \$ 4,413                               |
| Maintenance                     | 44,324                             | 22,039                                 |
| Professional services and other | 3,995                              | 6,418                                  |
|                                 | <b>\$ 53,761</b>                   | <b>\$ 32,870</b>                       |

The increase in deferred maintenance revenue is primarily due to our acquisition of Chordiant. See Note 5 Acquisition, Goodwill, and Intangibles for further discussion of the acquired assets and assumed liabilities from the acquisition.



**Table of Contents****8. ACCRUED RESTRUCTURING COSTS**

During the second quarter of 2010, in connection with the Company's integration plan of Chordiant, the Company recorded \$6.1 million of severance and related benefit costs for the reduction of approximately 50 personnel in redundant roles, primarily in general and administrative functions. These restructuring costs are all cash obligations of which approximately \$3.9 million is expected to be paid in the next 12 months and the remaining \$1.1 million by the end of the second quarter of 2012. The Company expects to incur an additional \$0.4 million in severance costs during the third quarter of 2010. In connection with the Company's evaluation of its combined facilities, the Company approved a plan to eliminate one redundant facility. As a result, the Company expects to incur approximately \$1.3 million in restructuring expenses by the end of 2010, representing future lease payments and demising costs, net of estimated sublease income and costs for this identified facility. These exit costs will be recognized when the Company ceases to use the leased facility, which is expected to occur by the end of 2010.

A summary of the restructuring activity during the second quarter of 2010 is as follows:

| <i>(in thousands)</i>       | <b>Personnel</b> |
|-----------------------------|------------------|
| Balance as of April 1, 2010 | \$ -             |
| Restructuring costs         | 6,080            |
| Cash payments               | (1,118)          |
| Balance as of June 30, 2010 | \$ 4,962         |

| <i>(in thousands)</i>       | <b>As of<br/>June 30,<br/>2010</b> |
|-----------------------------|------------------------------------|
| Reported as:                |                                    |
| Accrued expenses            | \$ 3,904                           |
| Other long-term liabilities | 1,058                              |
|                             | \$ 4,962                           |

**9. COMMITMENTS AND CONTINGENCIES**

The Company's principal administrative, sales, marketing, support, and research and development operations are located in a leased facility in Cambridge, Massachusetts. The lease for this facility expires in 2013, subject to the Company's option to extend for two additional five-year periods. The Company also leases space for its other offices under non-cancelable operating leases that expire on various dates through 2014.

As of June 30, 2010, the Company's future minimum rental payments required under operating leases with non-cancelable terms in excess of one year were as follows:

| <i>(in thousands)</i>       | <b>Net<br/>Operating<br/>Leases</b> |
|-----------------------------|-------------------------------------|
| <b>As of June 30, _____</b> |                                     |
| Remainder of 2010           | \$ 3,962                            |
| 2011                        | 7,856                               |
| 2012                        | 7,691                               |
| 2013                        | 3,979                               |
| 2014                        | 265                                 |
|                             | \$ 23,753                           |



**Table of Contents**

As of June 30, 2010, the Company did not have any additional unconditional purchase obligations.

In connection with the acquisition of Chordiant, the Company assumed an agreement with Ness Technologies Inc., Ness USA, Inc. and Ness Technologies India, Ltd. (collectively, Ness) that expires December 31, 2011. Pursuant to this agreement, Ness provides technical product support, sustaining engineering function, product testing services, product development services and other identified technical and consulting services to customers acquired from Chordiant. If the Company terminates the Ness agreement for convenience, it may be required to pay a termination fee of approximately \$0.4 million.

*Yue vs. Chordiant Software, Inc.*

On January 2, 2008, Chordiant and certain of its officers and one other employee were named in a complaint filed in the United States District Court for the Northern District of California (the Court) by Dongxiao Yue under the caption Dongxiao Yue (Plaintiff) v. Chordiant Software, Inc. et al. Case No. CV 08-0019 (N.D. Cal.). The complaint alleged that the Company's Marketing Director (CMD) software product infringed copyrights in certain software marketed by Netbula LLC. On May 14, 2010, a jury awarded the Plaintiff approximately \$1.4 million, which was accrued in the assumed Chordiant liabilities and included in accrued expenses in the consolidated balance sheet as of June 30, 2010. This judgment was approved by the Court on August 3, 2010, following the conclusion of various post-trial motions filed by the parties. The Company has not yet determined whether it will file an appeal in this matter.

**10. COMPREHENSIVE (LOSS) INCOME**

Comprehensive (loss) income includes the Company's net (loss) income plus the results of certain stockholders' equity changes not reflected in the unaudited condensed consolidated statements of operations. The components of comprehensive (loss) income are as follows:

| <i>(in thousands)</i>                            | <b>Three Months Ended<br/>June 30,</b> |             | <b>Six Months Ended<br/>June 30,</b> |             |
|--|--|-------------|--------------------------------------|-------------|
|  | <b>2010</b>                            | <b>2009</b> | <b>2010</b>                          | <b>2009</b> |
| Net (loss) income                                | \$ (8,188)                             | \$ 11,241   | \$ (4,337)                           | \$ 19,883   |
| Other comprehensive (loss) income:               |  |             |                                      |             |
| Unrealized gain (loss) on securities, net of tax | (3)                                    | (401)       | (541)                                | 20          |
| Foreign currency translation adjustments         | (1,114)                                | 1,011       | (1,447)                              | 901         |
| Comprehensive (loss) income                      | \$ (9,305)                             | \$ 11,851   | \$ (6,325)                           | \$ 20,804   |

**11. STOCK-BASED COMPENSATION**

For the second quarter and first six months of 2010 and 2009, stock-based compensation expense was reflected in the Company's unaudited condensed consolidated statements of operations as follows:

| <i>(in thousands)</i>                     | <b>Three Months Ended<br/>June 30,</b> |             | <b>Six Months Ended<br/>June 30,</b> |             |
|---|--|-------------|--------------------------------------|-------------|
|   | <b>2010</b>                            | <b>2009</b> | <b>2010</b>                          | <b>2009</b> |
| Cost of services                          | \$ 483                                 | \$ 128      | \$ 881                               | \$ 634      |
| Operating expenses                        | 1,703                                  | 732         | 2,751                                | 1,924       |
| Total stock-based compensation before tax | \$ 2,186                               | \$ 860      | \$ 3,632                             | \$ 2,558    |
| Income tax benefit                        | (578)                                  | (155)       | (1,091)                              | (739)       |

During the first six months of 2010, the Company issued approximately 395,000 shares to its employees under the Company's share-based compensation plans. Additional options to purchase approximately 241,000 shares were issued as replacement awards in connection with the

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acquisition of Chordiant. The compensation expense associated with the portion of the replacement awards related to post-combination services totaled \$0.2 million and will be recognized as compensation expense, in accordance with the accelerated recognition model over the remaining service period.

As of June 30, 2010, the Company had approximately \$7.1 million of unrecognized stock-based compensation expense related to all unvested RSUs and unvested stock options that is expected to be recognized over a weighted-average period of 2 years.



**Table of Contents****12. NET (LOSS) EARNINGS PER SHARE**

Basic (loss) 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 antidilutive in the periods presented, but could be dilutive in the future.

| <i>(in thousands, except per share amounts)</i>                       | <b>Three Months Ended<br/>June 30,</b> |             | <b>Six Months Ended<br/>June 30,</b> |             |
|---|--|-------------|--------------------------------------|-------------|
|   | <b>2010</b>                            | <b>2009</b> | <b>2010</b>                          | <b>2009</b> |
| <b>Basic</b>  |  |             |                                      |             |
| Net (loss) income   | \$ (8,188)                             | \$ 11,241   | \$ (4,337)                           | \$ 19,883   |
| Weighted-average common shares outstanding                            | 37,054                                 | 35,965      | 36,966                               | 35,818      |
| Net (loss) earnings per share, basic                                  | \$ (0.22)                              | \$ 0.31     | \$ (0.12)                            | \$ 0.56     |
| <b>Diluted</b>  |  |             |                                      |             |
| Net (loss) income   | \$ (8,188)                             | \$ 11,241   | \$ (4,337)                           | \$ 19,883   |
| Weighted-average common shares outstanding, basic                     | 37,054                                 | 35,965      | 36,966                               | 35,818      |
| Weighted-average effect of dilutive securities:                       |  |             |                                      |             |
| Stock options   | -                                      | 1,851       | -                                    | 1,721       |
| RSUs  | -                                      | 169         | -                                    | 159         |
| Warrants  | -                                      | 10          | -                                    | 10          |
| Effect of assumed exercise of stock options, warrants and RSUs        | -                                      | 2,030       | -                                    | 1,890       |
| Weighted-average common shares outstanding, diluted                   | 37,054                                 | 37,995      | 36,966                               | 37,708      |
| Net (loss) earnings per share, diluted                                | \$ (0.22)                              | \$ 0.30     | \$ (0.12)                            | \$ 0.53     |
| Outstanding options and RSUs excluded as impact would be antidilutive | 2,960                                  | 51          | 3,041                                | 617         |

**13. INCOME TAXES**

The Company accounts for income taxes at each interim period using its estimated annual effective tax rate. The provision for income taxes represents current and future amounts owed for federal, state, and foreign taxes.

During the second quarter and first six months of 2010, the Company recorded a benefit of \$3.3 million and \$0.9 million, respectively, on a pre-tax loss of \$11.5 million and \$5.2 million, respectively, which resulted in an effective tax rate of 28.9% and 16.9%, respectively. The Company recorded a discrete item related to the nondeductible portion of acquisition-related costs incurred in the second quarter and first six months of 2010 associated with the Chordiant acquisition, which reduced the tax benefit for the second quarter and first six months of 2010 by 2.9% and 13.5%, respectively.

The Company is in the process of evaluating its tax position related to the assets acquired and liabilities assumed from the Chordiant acquisition. The valuation of the assets acquired and liabilities assumed, including the measurement of the acquired net operating losses ( NOLs ), is preliminary and is subject to change until the Company has gathered all of the relevant factors that existed at the acquisition date. We are finalizing the determination of the acquired tax basis and measurement of valuation allowances and uncertain tax positions. There were no significant changes in our uncertain tax positions other than what may arise from the Chordiant acquisition since December 31, 2009.



**Table of Contents**

Our effective tax rate during the second quarter and first six months of 2009 was below the statutory federal income tax rate primarily due to the investment in tax-exempt municipal bonds and the benefit from the SEZ India tax holiday.

**14. GEOGRAPHIC INFORMATION AND MAJOR CUSTOMERS**

The Company operates in one operating segment rules-based Business Process Management ( BPM ) software. The Company derives substantially all of its revenue from the sale and support of one group of similar products and services. Substantially all of the Company's assets are located within the U.S. The Company derived its revenue from the following geographic areas (sales outside the U.S. are principally through export from the U.S.):

| <i>(Dollars in thousands)</i> | Three Months Ended<br>June 30, |       |           |       | Six Months Ended<br>June 30, |       |            |       |
|-------------------------------|--------------------------------|-------|-----------|-------|------------------------------|-------|------------|-------|
|                               | 2010                           |       | 2009      |       | 2010                         |       | 2009       |       |
| U.S.                          | \$ 49,254                      | 60 %  | \$ 41,709 | 65 %  | \$ 97,279                    | 62 %  | \$ 81,476  | 65 %  |
| United Kingdom                | 12,156                         | 15 %  | 10,944    | 17 %  | 22,862                       | 14 %  | 20,807     | 16 %  |
| Europe, other                 | 8,345                          | 10 %  | 8,020     | 13 %  | 21,389                       | 14 %  | 18,191     | 14 %  |
| Other                         | 12,491                         | 15 %  | 3,205     | 5 %   | 15,800                       | 10 %  | 5,771      | 5 %   |
|                               | \$ 82,246                      | 100 % | \$ 63,878 | 100 % | \$ 157,330                   | 100 % | \$ 126,245 | 100 % |

There were no customers accounting for more than 10% of the Company's total revenue. The following table summarizes the Company's concentration of credit risk associated with customers accounting for 10% or more of the Company's total outstanding trade receivables, and short and long-term license installments:

| <i>(Dollars in thousands)</i>                   | As of<br>June 30,<br>2010 | As of<br>December 31,<br>2009 |
|---|---------------------------|-------------------------------|
| <b>Trade receivables</b>                        | \$ 65,910                 | \$ 39,396                     |
| Customer A                                      | 14.4%                     | %                             |
| <b>Long and short-term license installments</b> | \$ 5,032                  | \$ 5,805                      |
| Customer B                                      | 49.1%                     | 42.7%                         |
| Customer C                                      | 17.9%                     | 20.5%                         |
| Customer D                                      | 15.5%                     | 16.8%                         |

## **Table of Contents**

### **Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

#### **Forward-Looking Statements**

This Quarterly Report on Form 10-Q contains or incorporates forward-looking statements within the meaning of section 27A of the Securities Act of 1933 and section 21E of the Securities Exchange Act of 1934. These forward-looking statements are based on current expectations, estimates, forecasts and projections about the industry and markets in which we operate and management's beliefs and assumptions. In addition, other written or oral statements that constitute forward-looking statements may be made by us or on our behalf. Words such as "expect," "anticipate," "intend," "plan," "believe," "could," "estimate," "may," "target," "project," or variations of such words and similar expressions are intended to identify such forward-looking statements. These statements are not guarantees of future performance and involve certain risks, uncertainties and assumptions that are difficult to predict.

We encourage you to carefully review the risk factors we have identified in Item 1A of Part I of our Annual Report on Form 10-K for the year ended December 31, 2009. We believe these risk factors could cause our actual results to differ materially from the forward-looking statements we make. We do not intend to update publicly any forward-looking statements, whether as a result of new information, future events or otherwise.

#### **Our products and services**

We develop and license rules-based BPM software and provide professional services, maintenance, and training related to our software. We focus our sales efforts on target accounts, which are companies or divisions within companies, and are typically large organizations that are among the leaders in their industry. Our strategy is to sell initial licenses to these target accounts that are focused on a specific purpose or area of operations, rather than selling large enterprise licenses. This strategy allows our customers to quickly realize business value from our software and limits their initial investment. Once a customer has realized this initial value, we work with the customer to identify opportunities for follow-on sales.

Our license revenue is primarily derived from sales of our PegaRULES Process Commander ( PRPC ) software and related solution frameworks. PRPC is a comprehensive platform for building and managing BPM applications that unifies business rules and business processes. Our solution frameworks are built on the capabilities of PRPC and are purpose- or industry-specific collections of best practice functionality to allow organizations to quickly implement new customer-facing practices and processes, bring new offerings to market, and provide customized or specialized processing. These products often require less implementation assistance than prior generations of our software products. In many cases this has resulted in a shorter sales process and implementation period. PRPC and related solution frameworks can be used by a broad range of customers within financial services, insurance and healthcare markets, as well as other markets, such as life sciences and government.

As a result of our acquisition of Chordiant Software, Inc. ( Chordiant ) and its customer experience management solutions, we acquired additional products that enable customers to maximize customer lifetime value through a suite of industry-leading technologies (Chordiant Decision Management, Chordiant Foundation Server, and Chordiant Marketing Director solutions). We expect to provide new releases of these products that include functional enhancements and improvements. We intend to remain a leader in the use of decision management to improve multi-channel customer experiences, provide better cross-sell/up-sell and aid customer retention. Our intent in this area is to make definition and deployment of decision strategies even easier by leveraging our thin-client design environment and our flexible, Build for Change ® configuration capabilities.

We also offer SmartPaaS, which is our platform-as-a service offering that allows customers to create PRPC applications using an internet-based infrastructure. This offering enables our customers to immediately build their applications in a secure environment while minimizing their infrastructure and hardware costs.

Our customers typically request professional services and training to assist them in implementing our products. Almost all of our customers also purchase maintenance on our products, which includes rights to upgrades and new releases, incident resolution and technical assistance. Professional services are provided directly by us and through our network of partners. By developing alliances with these partners, we have increased the supply of multi-skilled service consultants that can assist our customers.

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## **Table of Contents**

### **Business overview**

Our total revenue increased 29% and 25%, respectively, during the second quarter and first six months of 2010 compared to the same periods in 2009, primarily because of the increase in maintenance and professional services revenues associated with a higher number of license arrangements executed in 2009 and \$7.8 million of revenue directly attributable to the Chordiant operations. Due to the rapid integration of the sales force and operations of Chordiant, it will become increasingly difficult to separately identify revenue from arrangements attributable to Chordiant in future periods. We used \$6.3 million in cash from operations during the first six months of 2010 and generated \$29.4 million in cash from operations in the first six months of 2009. The primary components of cash used in operations during the first six months of 2010 were a \$4.3 million net loss, and an increase in working capital requirements due to a \$12.5 million increase in accounts receivable influenced by the timing of customer billings.

Through the first half of 2010, the value of new license arrangements in Europe and Asia was higher than in the first half of 2009. During the same period the value of new license arrangements in the financial services, insurance and government industries was higher than in the first half of 2009. The value of new license arrangements in the first half of 2010 in the healthcare industry was less than the same period in 2009. Overall, the aggregate value of new license arrangements in the first half of 2010 was slightly lower than in 2009. Historically, new license arrangements executed in the second half of the year are significantly higher than the first half.

We believe these results reflect our ability to quickly and successfully deliver our versatile Build for Change® technology to Fortune® 500 customers across industries and international borders, allowing these customers to reduce operating costs and increase revenues after a short implementation period. These operational efficiencies experienced by our customers are part of the strong value proposition our technology provides to our customers.

We believe the ongoing challenges for our business include our ability to continue to drive revenue growth, continue to expand our expertise in new and existing industries, remain a leader in the decision management market, and maintain our leadership position in the BPM market.

To address these challenges, during the first six months of 2010, we:

Completed the acquisition of Chordiant;

Invested in our research and development efforts and sales and marketing by significantly increasing headcount.

### ***Chordiant Acquisition***

On April 21, 2010, we acquired all of the outstanding common stock of Chordiant, a leading provider of customer relationship management ( CRM ) software and services with a focus on improving customer experiences through decision technology. The aggregate purchase price for Chordiant was approximately \$160.3 million consisting of \$156.8 million in cash and stock options with a fair value of \$3.5 million.

We believe the acquisition will expand our global customer base and provide complementary solutions. Chordiant clients will be able to incorporate Pegasystems process automation to enhance the functionality of their existing call center and marketing solutions. Pegasystems clients will benefit from Chordiant's decision management solutions and extensive CRM experience. In addition, we believe the combination of the two companies will expand the partner network and provide incremental growth. Both organizations share a vision of transforming multi-channel CRM through decisioning and process automation. The combination of Pegasystems and Chordiant will be able to deliver next-generation CRM that provides end-to-end customer experience functionality across organizations. We will focus our research and development efforts to deliver on this vision. We have gained significant expertise and knowledge via the Chordiant personnel who have been integrated with our existing resources.

The valuation of the acquired intangible assets and assumed liabilities is preliminary. The Company is currently in the process of investigating the facts and circumstances existing as of the acquisition date in order to finalize its valuation and establish the related tax basis.

During the second quarter of 2010, in connection with our integration plan, we recorded \$6.1 million of severance and related benefit costs for the reduction of approximately 50 personnel in redundant roles across multiple functions, primarily general and administrative functions. These restructuring costs are all cash costs and are expected to be paid by the end of the second quarter of 2012. We expect to incur an additional \$0.4 million in severance costs during the third quarter of 2010. In connection with our evaluation of our combined facilities, we approved a plan to

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eliminate one redundant facility. As a result, we expect to incur approximately \$1.3 million in restructuring expenses during the third quarter of 2010, representing future lease payments and demising costs, net of estimated sublease income for the identified facility. These exit costs will be recognized when we cease to use the leased facility, which is expected to occur by the end of 2010. In addition to these restructuring costs, during the second quarter of 2010, we recorded \$1.1 million in compensation and related benefits relating to Chordiant employees who are

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## **Table of Contents**

in transitional rolls and offices that we expect to close. We expect these operating expenses to be approximately \$0.4 million in the third quarter of 2010 and zero in the fourth quarter of 2010 as the transitional rolls end and the offices will be closed.

### **Critical accounting policies**

Management's Discussion and Analysis of Financial Condition and Results of Operations is based upon the condensed consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America ( U.S. GAAP ) and the rules and regulations of the SEC for interim financial reporting. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. We base our estimates and judgments on historical experience, knowledge of current conditions and beliefs of what could occur in the future given available information.

There have been no changes to our critical accounting policies as disclosed in our Annual Report on Form 10-K for the year ended December 31, 2009, other than as follows:

#### *Goodwill and Intangible Assets*

Goodwill represents the residual purchase price paid in a business combination after all identified assets and liabilities have been recorded. Goodwill is not amortized, but is tested annually for impairment by the use of a fair value model at a reporting unit level. If the fair value of the reporting unit is less than its carrying amount, we would determine the implied fair value of the goodwill and evaluate if it is impaired.

We evaluate our intangible assets for impairment whenever events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable. In evaluating potential impairment of these assets, we specifically consider whether any indicators of impairment are present, including, but not limited to:

whether there has been a significant adverse change in the business climate that affects the value of an asset;

whether there has been a significant change in the extent or manner in which an asset is used; and

whether there is an expectation that the asset will be sold or disposed of before the end of its originally estimated useful life.

If indicators of impairment are present, we compare the estimated undiscounted cash flows that the specific asset is expected to generate to its carrying value. These estimates involve significant subjectivity. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the asset exceeds its fair value.

#### *Valuation of Goodwill and Acquired Intangible Assets*

In connection with our acquisition of Chordiant and as a result of the preliminary purchase price allocation, we recorded \$90.4 million of intangible assets, relating principally to customer related intangible assets and acquired technology, and \$48.6 million of goodwill. The valuation of the acquired intangible assets and assumed liabilities is preliminary. The valuation process used to calculate the values assigned to these acquired intangible assets is complex and involves significant estimation relative to our financial projections. The principal component of the valuation process is the determination of discounted future cash flows, which are based on a number of estimates and assumptions. There is inherent uncertainty involved with this estimation process. The estimates and assumptions that are most sensitive include, but are not limited to:

the selection of an appropriate discount rate;

the required return on all assets employed by the valued asset to generate future income;

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our projected overall revenue growth and mix of revenue from a market participant's perspective;

our gross margin estimates (which are highly dependent on our mix of revenue);

our technology life cycles;

the attrition rate of our customers;

our planned level of operating expenses.

For more information regarding our critical accounting policies, we encourage you to read the discussion contained in Item 7 under the heading "Critical Accounting Policies and Estimates" and Note 2. "Significant Accounting Policies" included in the notes to the Consolidated Financial Statements contained in our Annual Report on Form 10-K for the year ended December 31, 2009.



**Table of Contents****Results of Operations**

|   | Three Months Ended |          | Increase (Decrease) |        | Six Months Ended |           | Increase (Decrease) |        |
|---|--------------------|----------|---------------------|--------|------------------|-----------|---------------------|--------|
|   | June 30,           |          |                     |        | June 30,         |           |                     |        |
|   | 2010               | 2009     |                     |        | 2010             | 2009      |                     |        |
| <i>(Dollars in thousands)</i>                             |                    |          |                     |        |                  |           |                     |        |
| Total revenue   | \$82,246           | \$63,878 | \$ 18,368           | 29%    | \$ 157,330       | \$126,245 | \$ 31,085           | 25%    |
| Gross profit  | 50,986             | 42,286   | 8,700               | 21%    | 99,634           | 84,122    | 15,512              | 18%    |
| Acquisition-related expenses                              | 3,395              | -        | 3,395               | n/m    | 4,903            | -         | 4,903               | n/m    |
| Restructuring expenses                                    | 6,080              | -        | 6,080               | n/m    | 6,080            | -         | 6,080               | n/m    |
| Other operating expenses                                  | 50,651             | 30,456   | 20,195              | 66%    | 89,229           | 59,957    | 29,272              | 49%    |
| Total operating expenses                                  | 60,126             | 30,456   | 29,670              | 97 %   | 100,212          | 59,957    | 40,255              | 67%    |
| (Loss) income before (benefit) provision for income taxes | \$(11,510)         | \$15,716 | \$ (27,226)         | (173)% | \$ (5,216)       | \$28,126  | \$(33,342)          | (119)% |
| n/m not meaningful  |                    |          |                     |        |                  |           |                     |        |

We continue to experience demand for our software products and related services, which we believe is due to the strong value proposition, short implementation period, and variety of licensing terms we offer our customers. Our success is also due to the growth in the BPM sector and our position as leader in this market space.

The increases in gross profit during the second quarter and first six months of 2010 compared to the same periods in 2009 were primarily due to the increases in maintenance revenue.

The decreases in income before provision for income taxes during the second quarter and first six months of 2010 compared to the same periods in 2009 were primarily due to the higher growth rate of our operating expenses, incremental expenses related to the Chordiant acquisition and the resulting restructuring costs, lower software license revenue as a percentage of total revenue and foreign currency transaction losses in 2010 as opposed to foreign currency gains in 2009.

The increase in operating expenses during the second quarter and first six months of 2010 included \$6.5 million of incremental Chordiant operating expenses.

Our loss before benefit for income taxes was primarily attributable to the \$5.5 million and \$7.7 million increase in foreign currency transaction losses during the second quarter and first six months of 2010, respectively, compared to the same periods in 2009.

A change in the number or size of high value license arrangements, or a change in the mix between perpetual and term licenses, can cause our revenues to fluctuate materially from quarter to quarter. The revenue growth rate achieved in any historical period is not necessarily indicative of the results expected for future periods.

**Table of Contents****Revenue**

|                               | Increase (Decrease) |              |                  |              |                  |            | Increase (Decrease) |              |                  |              |                 |           |
|-------------------------------|---------------------|--------------|------------------|--------------|------------------|------------|---------------------|--------------|------------------|--------------|-----------------|-----------|
|                               | Three Months Ended  |              |                  |              | Six Months Ended |            |                     |              | Six Months Ended |              |                 |           |
|                               | June 30,            |              | June 30,         |              | June 30,         |            | June 30,            |              | June 30,         |              | June 30,        |           |
|                               | 2010                | 2009         | 2010             | 2009         | 2010             | 2009       | 2010                | 2009         | 2010             | 2009         | 2010            | 2009      |
| <i>(Dollars in thousands)</i> |                     |              |                  |              |                  |            |                     |              |                  |              |                 |           |
| <b>License revenue</b>        |                     |              |                  |              |                  |            |                     |              |                  |              |                 |           |
| Perpetual licenses            | \$ 16,104           | 57 %         | \$ 16,130        | 63 %         | \$ (26)          | n/m        | \$ 33,108           | 56 %         | \$ 33,618        | 63 %         | \$ (510)        | (2)%      |
| Term licenses                 | 7,641               | 27 %         | 8,455            | 33 %         | (814)            | (10)%      | 18,561              | 32 %         | 17,788           | 33 %         | 773             | 4%        |
| Subscription                  | 4,455               | 16 %         | 1,066            | 4 %          | 3,389            | 318%       | 6,874               | 12 %         | 2,281            | 4 %          | 4,593           | 201%      |
| <b>Total license revenue</b>  | <b>\$ 28,200</b>    | <b>100 %</b> | <b>\$ 25,651</b> | <b>100 %</b> | <b>\$ 2,549</b>  | <b>10%</b> | <b>\$ 58,543</b>    | <b>100 %</b> | <b>\$ 53,687</b> | <b>100 %</b> | <b>\$ 4,856</b> | <b>9%</b> |

n/m = not meaningful

The mix between perpetual and term license arrangements fluctuates based on customer needs. Many of our perpetual license arrangements include extended payment terms and/or additional rights of use that delay the recognition of revenue to future periods. The aggregate value of payments due under these perpetual and certain subscription licenses was \$41.2 million as of June 30, 2010 compared to \$28.2 million as of June 30, 2009. See the table of future cash receipts by year from these perpetual licenses and certain subscription licenses on page 26.

We recognize revenue for our term license arrangements over the term of the agreement as payments become due or earlier if prepaid. The decrease in term license revenue during the second quarter of 2010 compared to the same period in 2009 was due to fewer arrangements and more prepayments of term licenses by a few customers during the second quarter of 2009. The aggregate value of payments due under term licenses was \$66.1 million as of June 30, 2010 compared to \$78.0 million as of June 30, 2009. A portion of the revenue related to the aggregate value of payments for term licenses signed during 2009, 2008, and 2007 was recognized during the second quarter and first six months of 2010. The remainder of the revenue under these agreements will be recognized in future periods. The aggregate value of future payments due under non-cancellable term licenses as of June 30, 2010 includes \$11.8 million of term license payments that we expect to recognize as revenue during the remainder of 2010. However, we expect our actual term license revenue for the remainder of 2010 could be higher than \$11.8 million as we complete new term license agreements in 2010 or if we receive prepayments from existing term license agreements. See the table of future cash receipts by year from these term licenses on page 26.

Subscription revenue primarily relates to our arrangements that include a right to unspecified future products and is recognized ratably over the term of the arrangement. The increases in subscription revenue during the second quarter and first six months of 2010 compared to the same periods in 2009 were primarily due to a new customer arrangement that began in the third quarter of 2009.

|                               | Three Months Ended |           | Increase |      | Six Months Ended |           | Increase  |      |
|-------------------------------|--------------------|-----------|----------|------|------------------|-----------|-----------|------|
|                               | June 30,           |           | June 30, |      | June 30,         |           | June 30,  |      |
|                               | 2010               | 2009      | 2010     | 2009 | 2010             | 2009      | 2010      | 2009 |
| <i>(Dollars in thousands)</i> |                    |           |          |      |                  |           |           |      |
| <b>Maintenance revenue</b>    |                    |           |          |      |                  |           |           |      |
| Maintenance                   | \$ 20,388          | \$ 12,171 | \$ 8,217 | 68%  | \$ 35,474        | \$ 24,119 | \$ 11,355 | 47%  |

The increases in maintenance revenue during the second quarter and first six months of 2010 compared to the same periods in 2009 were due to the continued increase in the aggregate value of the installed base of our software and \$3.9 million revenue contribution from Chordiant.

**Table of Contents**

|                                      | Three Months Ended |      |           |      | Increase | Six Months Ended |           |      |           | Increase |           |     |
|--------------------------------------|--------------------|------|-----------|------|----------|------------------|-----------|------|-----------|----------|-----------|-----|
|                                      | June 30,           |      |           |      |          | June 30,         |           |      |           |          |           |     |
|                                      | 2010               |      | 2009      |      |          | 2010             |           | 2009 |           |          |           |     |
| <i>(Dollars in thousands)</i>        |                    |      |           |      |          |                  |           |      |           |          |           |     |
| <b>Professional services revenue</b> |                    |      |           |      |          |                  |           |      |           |          |           |     |
| Consulting Services                  | \$ 32,000          | 95 % | \$ 25,108 | 96 % | \$ 6,892 | 27%              | \$ 59,719 | 94 % | \$ 46,281 | 96 %     | \$ 13,438 | 29% |
| Training                             | 1,658              | 5 %  | 948       | 4 %  | 710      | 75%              | 3,594     | 6 %  | 2,158     | 4 %      | 1,436     | 67% |

Total Professional services

\$ 33,658 100 % \$ 26,056 100 % \$ 7,602 29% \$ 63,313 100 % \$ 48,439 100 % \$ 14,874 31%

Professional services are primarily consulting services related to new license implementations. During the second quarter and first six months of 2010, the increases in consulting services and training were primarily due to a higher demand for these services in North America associated with new license arrangements executed in 2009 and \$3.9 million revenue contribution from Chordiant.

|                               | Three Months Ended |  |          |  | Increase | Six Months Ended |           |      |          | Increase |           |     |
|-------------------------------|--------------------|--|----------|--|----------|------------------|-----------|------|----------|----------|-----------|-----|
|                               | June 30,           |  |          |  |          | June 30,         |           |      |          |          |           |     |
|                               | 2010               |  | 2009     |  |          | 2010             |           | 2009 |          |          |           |     |
| <i>(Dollars in thousands)</i> |                    |  |          |  |          |                  |           |      |          |          |           |     |
| <b>Gross Profit</b>           |                    |  |          |  |          |                  |           |      |          |          |           |     |
| Software license              | \$27,091           |  | \$25,620 |  | \$1,471  | 6%               | \$ 57,403 |      | \$53,625 |          | \$ 3,778  | 7%  |
| Maintenance                   | 17,673             |  | 10,714   |  | 6,959    | 65%              | 30,822    |      | 21,225   |          | 9,597     | 45% |
| Professional services         | 6,222              |  | 5,952    |  | 270      | 5%               | 11,409    |      | 9,272    |          | 2,137     | 23% |
| Total gross profit            | \$ 50,986          |  | \$42,286 |  | \$8,700  | 21%              | \$99,634  |      | \$84,122 |          | \$ 15,512 | 18% |

Maintenance gross profit percent 87% 88% 87% 88%

Professional services gross profit percent 18% 23% 18% 19%

Gross profit percentage of professional services can vary quarter to quarter due to the timing of project completion, however, gross profit percent for each of software license, maintenance and professional services for the first six months of 2010 was relatively unchanged from the same period in 2009.

|                                     | Three Months Ended |  |      |  | Increase | Six Months Ended |          |      |      | Increase |          |     |
|-------------------------------------|--------------------|--|------|--|----------|------------------|----------|------|------|----------|----------|-----|
|                                     | June 30,           |  |      |  |          | June 30,         |          |      |      |          |          |     |
|                                     | 2010               |  | 2009 |  |          | 2010             |          | 2009 |      |          |          |     |
| <i>(Dollars in thousands)</i>       |                    |  |      |  |          |                  |          |      |      |          |          |     |
| <b>Amortization of intangibles:</b> |                    |  |      |  |          |                  |          |      |      |          |          |     |
| Cost of software license            | \$ 1,079           |  | \$31 |  | \$ 1,048 | n/m              | \$ 1,110 |      | \$62 |          | \$ 1,048 | n/m |

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|                            |         |      |         |     |         |      |         |     |
|----------------------------|---------|------|---------|-----|---------|------|---------|-----|
| Selling and marketing      | \$847   | \$-  | \$847   | n/m | \$847   | \$-  | \$847   | n/m |
| General and Administrative | \$47    | \$5  | \$42    | n/m | \$52    | \$10 | \$42    | n/m |
| Total amortization expense | \$1,973 | \$36 | \$1,937 | n/m | \$2,009 | \$72 | \$1,937 |     |

**Table of Contents**

The increases in amortization expense during the second quarter and first six months of 2010 compared to the same periods in 2009 were due to the amortization associated with the \$90.4 million of identifiable intangible assets recognized as a result of the preliminary purchase price allocation of Chordiant. The identifiable intangible assets are expected to be amortized over a weighted-average period of 8.4 years on a straight-line basis.

**Operating expenses**

|  | Three Months Ended |                  | Increase |  | Six Months Ended |                  | Increase |  |
|--|--------------------|------------------|----------|--|------------------|------------------|----------|--|
|  | 2010               | June 30,<br>2009 |          |  | 2010             | June 30,<br>2009 |          |  |

(Dollars in thousands)

**Selling and marketing**

|                               |           |          |           |     |           |          |           |     |
|-------------------------------|-----------|----------|-----------|-----|-----------|----------|-----------|-----|
| Selling and marketing         | \$ 29,896 | \$16,659 | \$ 13,237 | 79% | \$ 51,789 | \$32,095 | \$ 19,694 | 61% |
| As a percent of total revenue | 36%       | 26%      |           |     | 33%       | 25%      |           |     |

|  |  |  |  |  |     |     |     |     |
|--|--|--|--|--|-----|-----|-----|-----|
| Selling and marketing headcount at June 30 |  |  |  |  | 365 | 215 | 150 | 70% |
|--|--|--|--|--|-----|-----|-----|-----|

Selling and marketing expenses include compensation, benefits, and other headcount-related expenses associated with our selling and marketing personnel as well as advertising, promotions, trade shows, seminars, and other programs. The increase in selling and marketing expenses during the second quarter of 2010 compared to the same period in 2009 was primarily due to a \$4.6 million increase in compensation and benefit expenses associated with higher headcount, a \$1.3 million increase in travel expenses, \$2.7 million of incremental expenses related to Chordiant and \$1.9 million higher expenses related to marketing programs, including PegaWorld, our annual user conference held in April 2010. The increase in selling and marketing expenses during the first six months of 2010 compared to the same period in 2009 was primarily due to a \$8.4 million increase in compensation and benefit expenses associated with higher headcount, a \$2.1 million increase in travel expenses, \$2.7 million of incremental expenses related to Chordiant and \$2.1 million of higher expenses related to marketing programs, including PegaWorld. To provide coverage of additional accounts and geographies we significantly increased sales hiring in the first half of 2010 to create additional sales capacity for future periods. We plan to hire additional sales personnel in the second half of 2010, but at a lower rate as compared to the first half of 2010.

|  | Three Months Ended |                  | Increase |  | Six Months Ended |                  | Increase |  |
|--|--------------------|------------------|----------|--|------------------|------------------|----------|--|
|  | 2010               | June 30,<br>2009 |          |  | 2010             | June 30,<br>2009 |          |  |

(Dollars in thousands)

**Research and development**

|                               |           |         |          |     |           |          |          |     |
|-------------------------------|-----------|---------|----------|-----|-----------|----------|----------|-----|
| Research and development      | \$ 14,010 | \$9,149 | \$ 4,861 | 53% | \$ 25,636 | \$18,268 | \$ 7,368 | 40% |
| As a percent of total revenue | 17%       | 14%     |          |     | 16%       | 14%      |          |     |

|   |  |  |  |  |     |     |     |     |
|---|--|--|--|--|-----|-----|-----|-----|
| Research and development headcount at June 30 |  |  |  |  | 347 | 201 | 146 | 73% |
|---|--|--|--|--|-----|-----|-----|-----|

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Research and development expenses include compensation, benefits, contracted services, and other headcount-related expenses associated with research and development. The increase in headcount reflects organic growth as well as new employees from the Chordiant acquisition. The second quarter research and development expenses include only two months of compensation related to Chordiant employees. Other than the Chordiant acquisition, our increase in headcount was primarily in our Indian research facility thereby lowering our average compensation expense per employee.

The increase in research and development expenses during the second quarter of 2010 compared to the same period in 2009 was due to a \$1.4 million increase in compensation and benefit expenses associated with higher headcount primarily in our research and development facility in India, a \$0.5 million increase in engineering contractor expenses, and \$2.7 million of expenses related to Chordiant. The increase in research and development expenses during the first six months of 2010 compared to the same period in 2009 was due to a \$2.7 million increase in compensation and benefit expenses associated with higher headcount, a \$1.1 million increase in engineering contractor expenses, and \$2.7 million of incremental expenses related to Chordiant.

**Table of Contents**

|  | Three Months Ended |      | Increase | Six Months Ended |      | Increase |
|--|--------------------|------|----------|------------------|------|----------|
|  | June 30,           |      |          | June 30,         |      |          |
|  | 2010               | 2009 |          | 2010             | 2009 |          |

*(Dollars in thousands)***General and administrative**

|                               |          |         |          |      |           |         |          |     |
|-------------------------------|----------|---------|----------|------|-----------|---------|----------|-----|
| General and administrative    | \$ 6,745 | \$4,648 | \$ 2,097 | 45 % | \$ 11,804 | \$9,594 | \$ 2,210 | 23% |
| As a percent of total revenue | 8%       | 7%      |          |      | 8%        | 8%      |          |     |

|   |  |  |  |  |     |     |    |     |
|---|--|--|--|--|-----|-----|----|-----|
| General and administrative headcount at June 30 |  |  |  |  | 184 | 141 | 43 | 30% |
|---|--|--|--|--|-----|-----|----|-----|

General and administrative expenses include compensation, benefits, and other headcount-related expenses associated with the finance, legal, corporate governance, and other administrative headcount. It also includes accounting, legal, and other administrative fees.

The general and administrative headcount includes employees in human resources, information technology and corporate services departments whose costs are allocated to the rest of the Company's functional departments. The general and administrative headcount at June 30, 2010 also includes approximately 20 employees that are part of the restructuring related to the Chordiant acquisition and whose employment with the Company will end by the end of the third quarter of 2010.

The increase in general and administrative expenses during the second quarter of 2010 compared to the same period in 2009 was due to a \$0.2 million increase in compensation and benefit expenses associated with higher headcount, a \$0.3 million increase in contractor services expenses, a \$0.3 million increase in professional fees, and \$1.1 million of expenses related to Chordiant. The increase in general and administrative expenses during the first six months of 2010 compared to the same period in 2009 was due to a \$0.5 million increase in compensation and benefit expenses associated with higher headcount, a \$0.3 million increase in contracting services expense, and \$1.1 million of expenses related to Chordiant.

**Acquisition-related costs**

Acquisition-related costs are expensed as incurred and include costs to effect an impending or completed acquisition and direct and incremental costs associated with an acquisition. During the second quarter of 2010, the \$3.4 million of acquisition-related costs were primarily advisory fees, legal, tax consulting and valuation fees associated with our acquisition of Chordiant. During the first quarter of 2010, the \$1.5 million of acquisition related costs were primarily legal and advisory fees and due diligence costs associated with the acquisition.

**Restructuring costs**

The \$6.1 million of restructuring costs are severance and related benefit costs recognized during the second quarter of 2010 for the reduction of approximately 50 personnel in redundant roles, primarily in general and administrative functions. We expect to incur an additional \$0.4 million in severance costs during the third quarter of 2010. In connection with our evaluation of our combined facilities, we approved a plan to eliminate one redundant facility. As a result, we expect to incur approximately \$1.3 million in restructuring expenses during the end of 2010, representing future lease payments and demising costs, net of estimated sublease income for this identified facility. These exit costs will be recognized when we cease to use the leased facility, which is expected to occur by the end of 2010.

**Table of Contents****Stock-based compensation**

The following table summarizes stock-based compensation expense included in our consolidated statements of operations:

|   | Three Months Ended |       | Increase |      | Six Months Ended |         | Increase |     |
|---|--------------------|-------|----------|------|------------------|---------|----------|-----|
|   | June 30,           |       |          |      | June 30,         |         |          |     |
|   | 2010               | 2009  |          |      | 2010             | 2009    |          |     |
| <i>(Dollars in thousands)</i>             |                    |       |          |      |                  |         |          |     |
| <b>Stock-based compensation expense:</b>  |                    |       |          |      |                  |         |          |     |
| Cost of services                          | \$483              | \$128 | \$355    | 277% | \$881            | \$634   | \$ 247   | 39% |
| Operating expenses                        | 1,703              | 732   | 971      | 133% | 2,751            | 1,924   | 827      | 43% |
| Total stock-based compensation before tax | \$2,186            | \$860 | \$1,326  | 154% | \$3,632          | \$2,558 | 1,074    | 42% |
| Income tax benefit                        | (578)              | (155) |          |      | (1,091)          | (739)   |          |     |

The increases in stock-based compensation during the second quarter and first six months of 2010 compared to the same periods in 2009 were primarily due to our periodic stock option grants and new hire stock option grants.

|  | Three Months Ended |         | Change    |        | Six Months Ended |         | Change    |        |
|--|--------------------|---------|-----------|--------|------------------|---------|-----------|--------|
|  | June 30,           |         |           |        | June 30,         |         |           |        |
|  | 2010               | 2009    |           |        | 2010             | 2009    |           |        |
| <i>(Dollars in thousands)</i>                        |                    |         |           |        |                  |         |           |        |
| <b>Non-operating (loss) income and expenses, net</b> |                    |         |           |        |                  |         |           |        |
| Foreign currency transaction (loss) gain             | \$(2,542)          | \$2,923 | \$(5,465) | (187)% | \$(5,616)        | \$2,111 | \$(7,727) | (366)% |
| Interest income, net                                 | 119                | 881     | (762)     | (86)%  | 632              | 1,683   | (1,051)   | (62)%  |
| Installment receivable interest income               | 52                 | 75      | (23)      | (31)%  | 104              | 150     | (46)      | (31)%  |
| Other income, net                                    | 1                  | 7       | (6)       | (86)%  | 242              | 17      | 225       | n/m    |
| Non-operating (loss) income and expenses, net        | \$(2,370)          | \$3,886 | \$(6,256) | (161)% | \$(4,638)        | \$3,961 | \$(8,599) | 217%   |

n/m = not meaningful



*Non-operating (loss) income and expenses, net*

The increase in foreign currency transaction losses was due to the significant decrease in the value of the British pound and the Euro relative to the U.S. dollar and the higher total amount of foreign currency denominated net assets held in the U.S., consisting primarily of cash, receivables, license installments and accounts payable.

As a result of our acquisition of Chordiant, we have expanded our international operations. We hold U.S. dollars in these foreign operations whose functional currency is the Euro in order to partially offset our exposure to foreign currency transaction losses related to non-functional currencies held by our U.S. company.

The decreases in interest income and the increases in the realized gains for the second quarter and first six months of 2010 compared to the same periods in 2009 were due to the liquidation of our marketable securities used to pay for the Chordiant acquisition.

**Table of Contents*****(Benefit) provision for income taxes***

We account for income taxes at each interim period using our estimated annual effective tax rate. The provision for income taxes represents current and future amounts owed for federal, state, and foreign taxes.

During the second quarter and first six months of 2010, we recorded a benefit of \$3.3 million and \$0.9 million, respectively, on a pre-tax loss of \$11.5 million and \$5.2 million, respectively, which resulted in an effective tax rate of 28.9% and 16.9%, respectively. We recorded a discrete item related to the nondeductible portion of acquisition-related costs incurred in the second quarter and first six months of 2010 associated with the Chordiant acquisition, which reduced the tax benefit for the second quarter and first six months of 2010 by 2.9% and 13.5%, respectively.

We are in the process of evaluating our tax position related to the assets acquired and liabilities assumed from the Chordiant acquisition. The valuation of the assets acquired and liabilities assumed, including the valuation of the acquired net operating losses is preliminary and is subject to change until we have gathered all of the relevant facts that existed at the acquisition date.

Our effective tax rate during the second quarter and first six months of 2009 was below the statutory federal income tax rate primarily due to the investment in tax-exempt municipal bonds and the benefit from the SEZ India tax holiday.

**Liquidity and capital resources**

After the issuance of our March 31, 2010 interim financial statements, management identified an error in the presentation of currency transaction losses on foreign currency denominated cash and cash equivalents within the statement of cash flows. Please see Note 1 Accounting Policies in the accompanying notes to the unaudited condensed consolidated financial statements.

|   | Six Months Ended |                   |
|---|------------------|-------------------|
|   | 2010             | June 30,<br>2009  |
| <i>(in thousands)</i>                                   |                  |                   |
| Cash (used in) provided by:                             |                  |                   |
| Operating activities                                    | \$ (6,318)       | \$ 29,432         |
| Investing activities                                    | 14,628           | (12,789)          |
| Financing activities                                    | (3,031)          | (3,853)           |
| Effect of exchange rate on cash                         | (6,103)          | 919               |
| Net (decrease) increase in cash and cash equivalents    | \$ (824)         | \$ 13,709         |
|   | As of            | As of             |
|   | June 30, 2010    | December 31, 2009 |
| Total cash, cash equivalents, and marketable securities | \$ 74,041        | \$ 202,653        |

We have funded our operations primarily from cash provided by operations. Working capital was \$61.7 million as of June 30, 2010 compared to \$188.6 million as of December 31, 2009.

In April 2010, we acquired Chordiant for \$109.2 million in cash, net of approximately \$47.6 million of cash acquired.

In connection with the Company's integration plan of Chordiant and the reduction of approximately 50 employees, the Company paid approximately \$1.1 million in severance and related benefit costs during the second quarter of 2010. The Company expects to pay an additional \$5 million in severance and related benefit costs, of which \$3.9 million will be paid over the next 12 months and \$1.1 million by the second half of 2012.

We believe that our current cash, cash equivalents, and cash flow from operations will be sufficient to fund our operations and our share repurchase program for at least the next 12 months.

**Cash (used in) provided by operating activities**

The primary components of cash used in operations during the first six months of 2010 were a \$4.3 million net loss, a \$12.5 million increase in accounts receivable and \$5.5 million of excess tax benefits from exercise or vesting of equity awards.

The primary driver of cash provided by operations during the first six months of 2009 was net income of \$19.9 million.

**Table of Contents**Future Cash Receipts from License Arrangements

The following table summarizes the cash receipts due in connection with our existing license agreements as of June 30, 2010.

| <i>As of June 30, (in thousands)</i>              | <b>Installment<br/>payments for<br/>licenses recorded on<br/>the balance sheet (1)</b> | <b>Installment<br/>payments for term<br/>licenses not recorded<br/>on the balance sheet (2)</b> | <b>Other license payments not<br/>recorded on the<br/>balance<br/>sheet (3)</b> |
|---|--|---|---|
| Remainder of 2010                                 | \$ 1,828   | \$ 11,840   | \$ 15,921   |
| 2011  | 2,232  | 26,129  | 17,608  |
| 2012  | 1,292  | 18,031  | 7,704   |
| 2013  | -  | 7,543   | -   |
| 2014  | -  | 2,389   | -   |
| Thereafter  | -  | 206   | -   |
| <b>Total</b>                                      | <b>5,352</b>   | <b>\$ 66,138</b>  | <b>\$ 41,233</b>  |
| Unearned installment interest income              |  | (320)   |   |
| <b>Total license installments receivable, net</b> | <b>\$ 5,032</b>  |   |   |

- (1) These license installment payments have already been recognized as license revenue and are included in short- and long-term license installments in the accompanying unaudited condensed consolidated balance sheet as of June 30, 2010.
- (2) These amounts will be recognized as revenue in the future over the term of the agreement as payments become due or earlier if prepaid.
- (3) These amounts will be recognized as revenue in future periods and relate to perpetual and subscription licenses with extended payment terms and/or additional rights of use.

**Cash provided by (used) investing activities**

During the first quarter of 2010, we liquidated our marketable securities to pay for the Chordiant acquisition. During the second quarter of 2010, we paid \$109.0 million, net of cash acquired to complete the Chordiant acquisition.

During the first six months of 2009, cash used in investing activities was primarily for purchases of marketable debt securities of \$29.5 million, partially offset by the proceeds received from the sales, maturities and called marketable debt securities of \$18.5 million.

**Cash used in financing activities**

Cash used in financing activities during the first six months of 2010 and 2009 was primarily for repurchases of our common stock and the payment of our quarterly dividend. Since 2004, our Board of Directors has approved annual stock repurchase programs that have authorized the repurchase in the aggregate up to \$75.0 million of our common stock. Purchases under these programs have been made on the open market.

Share repurchases

The following table is a summary of our repurchase activity under all of our repurchase programs during the first six months of 2010 and 2009:

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|   | 2010   |           | 2009    |           |
|---|--------|-----------|---------|-----------|
| <i>(Dollars in thousands)</i>             | Shares | Amount    | Shares  | Amount    |
| Prior year authorization as of January 1, |        | \$ 15,779 |         | \$ 12,862 |
| Authorizations                            |        |           |         |           |
| Repurchases paid                          | 96,579 | (3,195)   | 570,954 | (8,824)   |
| Repurchases unsettled                     | 3,024  | (100)     |         |           |
| Authorization remaining as of June 30,    |        | \$ 12,484 |         | \$ 4,038  |

**Table of Contents**

In addition to the share repurchases made under our repurchase programs, we net settled the majority of our employee equity awards, which resulted in the withholding of shares to cover the stock option exercise price and the minimum statutory tax withholding obligations.

During the first six months of 2010 and 2009, our employees net settled equity awards representing the right to purchase a total of 623,000 shares and 1,704,000 shares, respectively, of which only 289,000 shares and 777,000 shares were issued to the employees and the balance of the shares were surrendered to us to pay for the exercise price and the applicable taxes. During the first six months of 2010 and 2009, instead of receiving cash from the equity holders, we withheld shares with a value of \$4.2 million and \$5.6 million, respectively, for withholding taxes, and \$4.7 million and \$15.1 million respectively, for the exercise price. The value of share repurchases and shares withheld for net settlement of our employee equity awards more than offset the proceeds received under our various share-based compensation plans during the first six months of 2010 and 2009.

**Dividends**

The Company declared a cash dividend of \$0.03 per share for each quarter during the first six months of 2010 and 2009, and paid cash dividends of \$2.2 million in both the first six months of 2010 and 2009. It is our current intention to pay a quarterly cash dividend of \$0.03 per share to shareholders of record as of the first trading day of each quarter, however, the Board of Directors may terminate or modify this dividend program at any time without notice.

**Contractual obligations**

As of June 30, 2010, we had material purchase obligations for customer support and consulting services and payments under operating leases. Our principal administrative, sales, marketing, support, and research and development operations are located in approximately 105,000 square foot leased facility in Cambridge, Massachusetts. The lease for this facility expires in 2013, subject to our option to extend for two additional five-year periods. We also lease space for our other offices under non-cancelable operating leases that expire on various dates through 2014.

As of June 30, 2010 our known contractual obligations, including future minimum rental payments required under operating leases with non-cancelable terms in excess of one year were as follows:

| <b>Contractual obligations:</b>           | <b>Payment due by period</b> |                                  |                            |                            |                           | <b>Other</b> |
|---|------------------------------|----------------------------------|----------------------------|----------------------------|---------------------------|--------------|
|   | <b>Total</b>                 | <b>Remainder<br/>of<br/>2010</b> | <b>2011 &amp;<br/>2012</b> | <b>2013 &amp;<br/>2014</b> | <b>2015 and<br/>after</b> |              |
| <b>(in thousands)</b>                     |                              |                                  |                            |                            |                           |              |
| Purchase obligations (1)                  | \$ 1,894                     | \$ 1,894                         | \$                         | \$                         | \$                        | \$           |
| Liability for uncertain tax positions (2) | 881                          | 881                              |                            |                            |                           |              |
| Operating lease obligations (3)           | 23,753                       | 3,962                            | 15,547                     | 4,244                      |                           |              |
| <b>Total</b>                              | <b>\$ 26,528</b>             | <b>\$ 6,737</b>                  | <b>\$ 15,547</b>           | <b>\$ 4,244</b>            | <b>\$</b>                 | <b>\$</b>    |

- (1) Represents the fixed or minimum amounts due under purchase obligations for customer support and consulting services.
- (2) We expect that the changes in the unrecognized benefits within the next twelve months will be approximately \$0.9 million related to tax positions for which the ultimate settlement is highly certain but for which there is uncertainty about the timing of such recognition. We are finalizing the determination of the acquired tax basis and measurement of valuation allowances and uncertain tax positions from Chordiant.
- (3) Includes deferred rent of approximately \$1.1 million included in accrued expenses and approximately \$1.8 million in other long-term liabilities in the accompanying consolidated balance sheet as of June 30, 2010.

## **Table of Contents**

### **Item 3. Quantitative and Qualitative Disclosures about Market Risk**

Market risk represents the risk of loss that may affect us due to adverse changes in financial market prices and rates. Our market risk exposure is primarily related to fluctuations in foreign exchange rates and interest rates. We have not entered into derivative or hedging transactions to manage risk in connection with such fluctuations.

#### *Foreign currency exposure*

We derived approximately 38% and 35% of our total revenue from sales to customers based outside of the United States ( U.S. ) during the first six months of 2010 and 2009, respectively. Our international license and professional services have increasingly become denominated in foreign currencies. However, the operating expenses of our foreign operations are also primarily denominated in foreign currencies, which partially offset our foreign currency exposure. A decrease in the value of foreign currencies, particularly the British pound and the Euro relative to the U.S. dollar, could adversely impact our revenues and operating results.

Most of our transactions with customers are invoiced from our offices in the U.S. For those transactions that are denominated in currencies other than the U.S. dollar, we have receivables and license installments that are valued in foreign currencies. Our U.S. operating company holds cash in foreign currencies in order to support our foreign operations. Our functional currency is primarily the U.S. dollar, therefore, when there are changes in the foreign currency exchange rates versus the U.S. dollar, we recognize a foreign currency transaction gain or (loss) in our consolidated statements of operations. In addition, our foreign subsidiaries have intercompany accounts that are eliminated in consolidation, but that expose us to foreign currency exchange rate fluctuation. Foreign currency exchange rate fluctuations on our short-term intercompany accounts are recorded as foreign currency transaction gains or (losses) in our consolidated statements of operations.

As a result of our acquisition of Chordiant, we have expanded our international operations. We hold U.S. dollars in these foreign operations whose functional currency is the Euro in order to partially offset our exposure to foreign currency transaction losses related to non-functional currencies held by our U.S. company. As of June 30, 2010, we held cash and receivables subject to foreign currency transaction gains or (losses) with a carrying value of approximately \$20.2 million. The carrying value of these monetary assets includes the netting of U.S. dollar denominated monetary assets held in certain foreign operations whose functional currency is the Euro with the foreign currency monetary assets held by our U.S. operations.

During the first six months of 2010, we recorded a \$5.6 million foreign currency transaction loss due to the decrease in the value of foreign currencies, primarily the Euro and British pound, relative to the U.S. dollar. As of June 30, 2010, a ten percent change in foreign currency exchange rates would have changed the carrying value of our net monetary assets by approximately \$2.0 million as of that date with a corresponding currency gain (loss) recognized in our consolidated statement of operations.

#### *Interest rate exposure*

In March 2010, we liquidated our marketable securities and invested the proceeds primarily in money market funds in preparation to pay for the Chordiant acquisition. In April 2010, we acquired Chordiant for a cash purchase price of approximately \$109.2 million, net of approximately \$47.6 million of cash acquired. We invested the cash primarily in money market funds, government sponsored enterprises and foreign currencies. As a result, we are not subject to significant interest rate risk.

**Table of Contents****Item 4. Controls and Procedures***(a) Evaluation of Disclosure Controls and Procedures.*

Our management, with the participation of our Chief Executive Officer, or CEO, and Chief Financial Officer, or CFO, evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act) as of June 30, 2010. In designing and evaluating our disclosure controls and procedures, our management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives, and our management necessarily applied its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on this evaluation, our CEO and CFO concluded that our disclosure controls and procedures were effective as of June 30, 2010.

*(b) Changes in Internal Control over Financial Reporting.*

There have been no changes in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act) during the quarter ended June 30, 2010 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**Part II Other Information:****Item 1A. Risk Factors**

We encourage you to carefully consider the risk factors identified in Part I, Item 1A. Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2009. These risk factors could materially affect our business, financial condition and future results and could cause our actual business and financial results to differ materially from those contained in forward-looking statements made in this Quarterly Report on Form 10-Q or elsewhere by management from time to time. There have been no material changes during the first six months of 2010 to the risk factors disclosed in our Annual Report on Form 10-K for the year ended December 31, 2009.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

The following table sets forth information regarding our repurchases of our common stock during the second quarter of 2010:

| Period         | Total Number<br>of Shares<br>Purchased | Average Price<br>Paid per<br>Share | Approximate Dollar<br>Value of Shares That<br>May Yet Be Purchased |   |
|----------------|--|------------------------------------|--|---|
|                |  |                                    | Repurchase<br>Programs (1)   | Repurchase Programs<br>(in thousands) (1) |
| 4/1/10-4/30/10 | 15,070                                 | \$ 34.54                           | 15,070   | \$ 13,698                                 |
| 5/1/10-5/31/10 | 22,579                                 | 30.81                              | 22,579   | 13,002                                    |
| 6/1/10-6/30/10 | 17,655                                 | 29.34                              | 17,655   | 12,484                                    |
| Total          | 55,304                                 | \$ 31.36                           |  |   |

(1)



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Since 2004, our Board of Directors has approved annual stock repurchase programs that have authorized the repurchase, in the aggregate, up to \$75.0 million of our common stock. The most recent \$15 million repurchase program was publicly announced on November 24, 2009 and expires December 31, 2010. Under this program, purchases will be made from time to time on the open market or in privately negotiated transactions. Shares may be repurchased in such amounts as market conditions warrant, subject to regulatory and other considerations. The Company has established a pre-arranged stock repurchase plan, intended to comply with the requirements of Rule 10b5-1 under the Securities Exchange Act of 1934, as amended, and of Rule 10b-18 of the Exchange Act (the "10b5-1 Plan"). All share repurchases under the Fourth Program during closed trading window periods will be made pursuant to the 10b5-1 Plan.

**Table of Contents**

**Item 6. Exhibits**

The exhibits listed in the Exhibit Index immediately preceding such exhibits are filed as part of this report and such Exhibit Index is incorporated herein by reference.

**Table of Contents**

**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

**Pegasystems Inc.**

Date: August 9, 2010

By: /s/ CRAIG DYNES  
Craig Dynes  
Senior Vice President, Chief Financial Officer  
(principal financial officer)  
  
(duly authorized officer)

**Table of Contents**

**PEGASYSTEMS INC.**

**Exhibit Index**

| <b>Exhibit No.</b> | <b>Description</b>   |
|--------------------|--|
| 31.1               | Certification pursuant to Exchange Act Rules 13a-14 and 15d-14 of the Chief Executive Officer.                   |
| 31.2               | Certification pursuant to Exchange Act Rules 13a-14 and 15d-14 of the Chief Financial Officer.                   |
| 32                 | Certification pursuant to 18 U.S.C. Section 1350 of the Chief Executive Officer and the Chief Financial Officer. |