PEGASYSTEMS INC
Form 10-Q
August 09, 2012
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2012

or

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

For the transition period from to

Commission File Number: 1-11859

PEGASYSTEMS INC.

(Exact name of Registrant as specified in its charter)

Massachusetts	**04-2787865**
(State or other jurisdiction of	***(IRS Employer***
incorporation or organization)	***Identification No.)***
101 Main Street Cambridge, MA	**02142-1590**
(Address of principal executive offices)	***(Zip Code)***

(617) 374-9600

(Registrant s telephone number including area code)

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x 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 x	Accelerated filer ¨	Non-accelerated filer ¨ (Do not check if smaller reporting company)	Smaller reporting company ¨

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

There were 37,906,098 shares of the Registrant s common stock, $.01 par value per share, outstanding on July 30, 2012.

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PEGASYSTEMS INC.

UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands)

	As of June 30, 2012	As of December 31, 2011
ASSETS		
Current assets:		
Cash and cash equivalents	$ 54,827	$ 60,353
Marketable securities	48,037	51,079
Total cash, cash equivalents, and marketable securities	102,864	111,432
Trade accounts receivable, net of allowance of $1,165 and $926	92,542	98,293
Deferred income taxes	9,827	9,826
Income taxes receivable	10,035	7,545
Other current assets	5,512	4,865
Total current assets	220,780	231,961
Property and equipment, net	28,175	14,458
Long-term deferred income taxes	43,581	43,286
Long-term other assets	1,782	2,186
Intangible assets, net	63,787	69,369
Goodwill	20,451	20,451
Total assets	$ 378,556	$ 381,711
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 7,405	10,899
Accrued expenses	21,597	18,336
Accrued compensation and related expenses	26,240	39,170
Deferred revenue	79,358	73,840
Total current liabilities	134,600	142,245
Income taxes payable	9,633	9,547
Long-term deferred revenue	11,898	15,367
Other long-term liabilities	10,813	5,796
Total liabilities	166,944	172,955
Commitments and contingencies		
Stockholders equity:		
Preferred stock, 1,000 shares authorized; no shares issued and outstanding		
Common stock, 100,000 shares and 70,000 shares authorized; 37,890 shares and 37,712 shares issued and outstanding	379	377
Additional paid-in capital	133,057	129,701
Retained earnings	76,547	77,029
Accumulated other comprehensive income	1,629	1,649
Total stockholders equity	211,612	208,756

Total liabilities and stockholders equity	$	378,556	$	381,711

See notes to unaudited condensed consolidated financial statements.

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PEGASYSTEMS INC.

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(in thousands, except per share amounts)

	Three Months Ended June 30, 2012	Three Months Ended June 30, 2011	Six Months Ended June 30, 2012	Six Months Ended June 30, 2011
Revenue:				
Software license	$ 30,999	$ 34,645	$ 66,942	$ 68,107
Maintenance	34,495	28,294	65,340	55,742
Professional services	39,562	40,579	83,941	82,029
Total revenue	105,056	103,518	216,223	205,878
Cost of revenue:				
Cost of software license	1,579	1,631	3,178	3,305
Cost of maintenance	3,718	3,260	7,327	6,634
Cost of professional services	34,690	35,506	71,016	70,474
Total cost of revenue	39,987	40,397	81,521	80,413
Gross profit	65,069	63,121	134,702	125,465
Operating expenses:				
Selling and marketing	41,188	37,208	79,583	71,244
Research and development	18,901	15,696	37,905	30,829
General and administrative	7,664	6,839	13,979	13,971
Acquisition-related costs		144		482
Restructuring costs				141
Total operating expenses	67,753	59,887	131,467	116,667
(Loss) income from operations	(2,684)	3,234	3,235	8,798
Foreign currency transaction (loss) gain	(841)	173	(101)	1,189
Interest income, net	94	91	205	177
Other income (expense), net	263	(167)	(576)	(139)
(Loss) income before (benefit) provision for income taxes	(3,168)	3,331	2,763	10,025
(Benefit) provision for income taxes	(901)	1,058	973	3,021
Net (loss) income	$ (2,267)	$ 2,273	$ 1,790	$ 7,004
(Loss) earnings per share:				
Basic	$ (0.06)	$ 0.06	$ 0.05	$ 0.19
Diluted	$ (0.06)	$ 0.06	$ 0.05	$ 0.18
Weighted-average number of common shares outstanding				
Basic	37,865	37,405	37,812	37,341
Diluted	37,865	38,851	38,931	38,828

Cash dividends declared per share	$ 0.03	$ 0.03	$ 0.06	$ 0.06

See notes to unaudited condensed consolidated financial statements.

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PEGASYSTEMS INC.

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(in thousands)

(in thousands)	Three Months Ended June 30, 2012	Three Months Ended June 30, 2011	Six Months Ended June 30, 2012	Six Months Ended June 30, 2011
Net (loss) income	$ (2,267)	$ 2,273	$ 1,790	$ 7,004
Other comprehensive income (loss), net of tax:				
Unrealized (loss) gain on securities, net of tax	(25)	42	47	26
Foreign currency translation adjustments	(1,341)	476	(67)	1,764
Total other comprehensive (loss) income	(1,366)	518	(20)	1,790
Comprehensive (loss) income	$ (3,633)	$ 2,791	$ 1,770	$ 8,794

See notes to unaudited condensed consolidated financial statements.

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PEGASYSTEMS INC.

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

	Six Months Ended June 30, 2012	2011
Operating activities:		
Net income	$ 1,790	$ 7,004
Adjustment to reconcile net income to cash provided by operating activities:		
Excess tax benefits from exercise or vesting of equity awards	(2,225)	(4,011)
Deferred income taxes	(305)	(83)
Depreciation and amortization	8,635	8,228
Stock-based compensation expense	5,838	4,400
Foreign currency transaction loss	460	377
Other	753	414
Change in operating assets and liabilities:		
Trade accounts receivable	5,795	(15,790)
Income taxes receivable and other current assets	(942)	1,547
Accounts payable and accrued expenses	(14,203)	(2,761)
Deferred revenue	2,037	18,395
Other long-term assets and liabilities	4,894	(500)
Cash provided by operating activities	12,527	17,220
Investing activities:		
Purchase of marketable securities	(11,760)	(25,361)
Matured and called marketable securities	14,207	7,738
Sale of marketable securities		1,047
Investment in property and equipment	(14,949)	(3,563)
Cash used in investing activities	(12,502)	(20,139)
Financing activities:		
Issuance of common stock for share-based compensation plans	707	1,707
Excess tax benefits from exercise or vesting of equity awards	2,225	4,011
Dividend payments to shareholders	(2,272)	(2,238)
Common stock repurchases for tax withholdings for net settlement of equity awards	(2,851)	(3,569)
Common stock repurchases under share repurchase programs	(2,526)	(2,084)
Cash used in financing activities	(4,717)	(2,173)
Effect of exchange rate on cash and cash equivalents	(834)	948
Net decrease in cash and cash equivalents	(5,526)	(4,144)
Cash and cash equivalents, beginning of period	60,353	71,127
Cash and cash equivalents, end of period	$ 54,827	$ 66,983

See notes to unaudited condensed consolidated financial statements.

PEGASYSTEMS INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. ACCOUNTING POLICIES

Basis of Presentation

Pegasystems Inc. (together with its subsidiaries, the Company) has prepared the accompanying unaudited condensed consolidated financial statements pursuant to the rules and regulations of the 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, 2011.

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 2012.

2. NEW ACCOUNTING PRONOUNCEMENTS

Disclosures About Offsetting Assets and Liabilities: In December 2011, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2011-11, *Balance Sheet (Topic 210): Disclosures About Offsetting Assets and Liabilities* , which creates new disclosure requirements regarding the nature of an entity s rights of setoff and related arrangements associated with its financial instruments and derivative instruments. Certain disclosures of the amounts of certain instruments subject to enforceable master netting arrangements or similar agreements would be required, irrespective of whether the entity has elected to offset those instruments in the statement of financial position. This ASU is effective for the Company on January 1, 2013 with retrospective application required. The adoption of this standard will not impact the Company s financial position or results of operations as this accounting standard only requires enhanced disclosure.

3. MARKETABLE SECURITIES

(in thousands)	June 30, 2012			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
Marketable securities:				
Municipal bonds	$ 30,624	82	(8)	$ 30,698
Corporate bonds	15,286	55	(2)	15,339
Government sponsored enterprise bonds	2,000			2,000
Marketable securities	$ 47,910	137	(10)	$ 48,037

(in thousands)	December 31, 2011			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
Marketable securities:				
Municipal bonds	$ 27,968	74	(2)	$ 28,040
Corporate bonds	15,058	16	(34)	15,040
Government sponsored enterprise bonds	8,001	2	(4)	7,999
Marketable securities	$ 51,027	92	(40)	$ 51,079

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

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As of June 30, 2012, remaining maturities of marketable debt securities ranged from July 2012 to December 2014, with a weighted-average remaining maturity of approximately 12 months.

4. DERIVATIVE INSTRUMENTS

The Company uses forward foreign currency contracts to manage its exposure to changes in foreign currency exchange rates associated with its foreign currency denominated accounts receivable and cash. The U.S. operating company invoices most of its foreign customers in foreign currencies, which results in cash and receivables held at the end of the reporting period denominated in these foreign currencies. Since the U.S. operating company s functional currency is the U.S. dollar, the Company recognizes a foreign currency transaction gain or (loss) on the foreign currency denominated cash and accounts receivable held by the U.S. operating company in its consolidated statements of income when there are changes in the foreign currency exchange rates versus the U.S. dollar. The Company is primarily exposed to changes in the value of the Euro and British pound relative to the U.S. dollar. The forward foreign currency contracts utilized by the Company are not designated as hedging instruments and as a result, the Company records the fair value of these contracts at the end of each reporting period in its consolidated balance sheet as other current assets for unrealized gains and accrued expenses for unrealized losses, with any fluctuations in the value of these contracts recognized in other (expense) income, net, in its consolidated statement of income. However, the fluctuations in the value of these forward foreign currency contracts partially offset the gains and losses from the remeasurement or settlement of the foreign currency denominated accounts receivable and cash held by the U.S. operating company, thus partly mitigating the volatility. Generally, the Company enters into forward foreign currency contracts with terms not greater than 90 days.

During the first six months of 2012, the Company entered into and settled forward foreign currency contracts to sell 27.2 million and £23 million and receive in exchange $71.4 million. During the first six months of 2011, the Company entered into and settled forward foreign currency contracts to sell 17 million and £12 million and receive in exchange $44 million. As of June 30, 2012 and December 31, 2011, the Company did not have any forward foreign currency contracts outstanding. During the second quarter and first six months of 2012, the change in the fair value of the Company s forward foreign currency contracts recorded in other income (expense), net, was a gain of $0.2 million and a loss of $0.6 million, respectively. During the second quarter and first six months of 2011, the change in the fair value of the Company s forward foreign currency contracts recorded in other income (expense), net, was a loss of $0.2 million.

5. FAIR VALUE MEASUREMENTS

Assets Measured at Fair Value on a Recurring Basis

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

The Company s investments classified within Level 1 of the fair value hierarchy are valued using quoted market prices. The Company s investments classified within Level 2 of the fair value hierarchy are valued based on matrix pricing compiled by third party pricing vendors, using observable market inputs such as interest rates, yield curves, and credit risk.

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

(in thousands)	June 30, 2012	Fair Value Measurements at Reporting Date Using: Quoted Prices in Active Markets for Identical Assets (Level 1)	Fair Value Measurements at Reporting Date Using: Significant Other Observable Inputs (Level 2)
Money market funds	$ 2,825	$ 2,825	$
Marketable securities:			
Government sponsored enterprise bonds	$ 2,000	$	$ 2,000
Corporate bonds	15,339	14,333	1,006
Municipal bonds	30,698	10,669	20,029
Total marketable securities	$ 48,037	$ 25,002	$ 23,035

(in thousands)	December 31, 2011	Fair Value Measurements at Reporting Date Using: Quoted Prices in Active Markets for Identical Assets (Level 1)	Fair Value Measurements at Reporting Date Using: Significant Other Observable Inputs (Level 2)
Money market funds	$ 3,067	$ 3,067	$
Marketable securities:			
Municipal bonds	$ 28,040	$ 6,110	$ 21,930
Corporate bonds	15,040	15,040	0
Government sponsored enterprise bonds	7,999	2,001	5,998
Total marketable securities	$ 51,079	$ 23,151	$ 27,928

Assets Measured at Fair Value on a Nonrecurring Basis

Assets not recorded at fair value on a recurring basis, such as property and equipment, and intangible assets, are recognized at fair value when they are impaired. During the first six months of 2012 and 2011, the Company did not recognize any nonrecurring fair value measurements from impairments.

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6. TRADE ACCOUNTS RECEIVABLE, NET OF ALLOWANCES

(in thousands)	June 30, 2012	December 31, 2011
Trade accounts receivable	$ 67,635	$ 77,123
Unbilled trade accounts receivable	26,072	22,096
Total accounts receivable	93,707	99,219
Allowance for doubtful accounts		(31)
Allowance for sales credit memos	(1,165)	(895)
Total allowance	(1,165)	(926)
	$ 92,542	$ 98,293

Unbilled trade accounts receivable relate to services earned under time and material arrangements, and maintenance and license arrangements that had not been invoiced as of June 30, 2012 and December 31, 2011, respectively.

7. GOODWILL AND OTHER INTANGIBLE ASSETS

There were no changes in the carrying amount of goodwill during the first six months of 2012.

Intangible assets are recorded at cost and are amortized using the straight-line method over their estimated useful life, which range from 5 to 9 years.

(in thousands)	Cost	Accumulated Amortization	Net Book Value
As of June 30, 2012			
Customer related intangibles	$ 44,355	$ (10,678)	$ 33,677
Technology	43,446	(13,351)	30,095
Trade name	248	(248)	
Technology designs	490	(490)	
Non-compete agreements	100	(85)	15
Intellectual property	1,400	(1,400)	
Total	$ 90,039	$ (26,252)	$ 63,787

	Cost	Accumulated Amortization	Net Book Value
As of December 31, 2011			
Customer related intangibles	$ 44,355	$ (8,214)	$ 36,141
Technology	43,446	(10,269)	33,177
Trade name	248	(248)	
Technology designs	490	(463)	27
Non-compete agreements	100	(76)	24
Intellectual property	1,400	(1,400)	
Total	$ 90,039	$ (20,670)	$ 69,369

For the second quarter and first six months of 2012 and 2011, amortization of intangibles was reflected in the Company s unaudited condensed consolidated statements of income as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
(in thousands)	**2012**	**2011**	**2012**	**2011**
Cost of software license	$ 1,540	$ 1,571	$ 3,108	$ 3,142
Selling and marketing	1,232	1,232	2,464	2,464
General and administrative	5	26	10	93
Total amortization expense	$ 2,777	$ 2,829	$ 5,582	$ 5,699

Amortization of intangibles is estimated to be recorded over their remaining useful lives as follows:

(in thousands) **As of June 30,**	**Future estimated amortization expense**
Remainder of 2012	$ 5,554
2013	11,095
2014	9,489
2015	8,688
2016	8,688
2017	8,688
2018 and thereafter	11,585
	$ 63,787

8. ACCRUED EXPENSES

(in thousands)	**June 30, 2012**	**December 31, 2011**
Other taxes	$ 3,242	$ 2,759
Restructuring	416	626
Professional fees	778	1,146
Income taxes	1,178	1,954
Professional services partners fees	490	120
Short-term deferred rent	1,675	1,428
Self-insurance health and dental claims	1,119	1,931
Dividends payable	1,137	1,132
Employee reimbursable expenses	1,923	897
Construction in process	2,081	
Other	7,558	6,343
	$ 21,597	$ 18,336

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9. DEFERRED REVENUE

(in thousands)	June 30, 2012	December 31, 2011
Software license	$ 12,642	$ 15,005
Maintenance	59,972	50,916
Professional services and other	6,744	7,919
Current deferred revenue	79,358	73,840
Software license	11,307	13,532
Maintenance and professional services	591	1,835
Long-term deferred revenue	11,898	15,367
	$ 91,256	$ 89,207

10. ACCRUED RESTRUCTURING COSTS

During 2010, in connection with the Company s integration plan of Chordiant, the Company recorded $6.5 million of severance and related benefit costs, which were paid by the end of the first quarter of 2012. Also, in connection with the Company s evaluation of its combined facilities, the Company eliminated space within one facility and recognized $1.6 million of restructuring expenses, representing future lease payments and demising costs, net of estimated sublease income for this space. The lease expires at the end of 2013.

A summary of the restructuring activity during the first six months of 2012 is as follows:

(in thousands)	Personnel	Facilities	Total
Balance as of December 31, 2011	$ 243	$ 800	$ 1,043
Cash payments	(243)	(160)	(403)
Balance as of June 30, 2012	$	$ 640	$ 640

(in thousands)	June 30, 2012	December 31, 2011
Reported as:		
Accrued expenses	$ 416	$ 626
Other long-term liabilities	224	417
	$ 640	$ 1,043

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11. STOCK-BASED COMPENSATION

For the second quarter and first six months of 2012 and 2011, stock-based compensation expense was reflected in the Company s unaudited condensed consolidated statements of income as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
(in thousands)	**2012**	**2011**	**2012**	**2011**
Cost of services	$ 884	$ 553	$ 1,861	$ 1,350
Operating expenses	2,102	1,312	3,977	3,050
Total stock-based compensation before tax	$ 2,986	$ 1,865	$ 5,838	$ 4,400
Income tax benefit	(990)	(613)	(1,866)	(1,499)

During the first six months of 2012, the Company issued approximately 237,000 shares to its employees under the Company s share-based compensation plans.

During the first six months of 2012, the Company granted approximately 122,000 restricted stock units (RSUs) with a total fair value of $4.2 million. Approximately 52,000 RSUs were issued in connection with the election by employees to receive 50% of their 2012 target incentive compensation under the Company s Corporate Incentive Compensation Plan (the CICP) in the form of RSUs instead of cash. The total stock-based compensation of approximately $1.9 million associated with this RSU grant will be recognized over one year.

As of June 30, 2012, the Company had approximately $12 million of unrecognized stock-based compensation expense, net of estimated forfeitures, related to all unvested RSUs and unvested stock options that is expected to be recognized over a weighted-average period of 2.1 years.

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12. EARNINGS PER SHARE

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

	Three Months Ended June 30,		Six Months Ended June 30,	
(in thousands, except per share amounts)	**2012**	**2011**	**2012**	**2011**
Basic				
Net (loss) income	$ (2,267)	$ 2,273	$ 1,790	$ 7,004
Weighted-average common shares outstanding	37,865	37,405	37,812	37,341
(Loss) earnings per share, basic	$ (0.06)	$ 0.06	$ 0.05	$ 0.19
Diluted				
Net (loss) income	$ (2,267)	$ 2,273	$ 1,790	$ 7,004
Weighted-average common shares outstanding, basic	37,865	37,405	37,812	37,341
Weighted-average effect of dilutive securities:				
Stock options		1,201	849	1,241
RSUs		242	269	242
Warrants		3	1	4
Effect of assumed exercise of stock options, warrants and RSUs		1,446	1,119	1,487
Weighted-average common shares outstanding, diluted	37,865	38,851	38,931	38,828
(Loss) earnings per share, diluted	$ (0.06)	$ 0.06	$ 0.05	$ 0.18
Outstanding options and RSUs excluded as impact would be antidilutive	1,146	31	54	27

13. GEOGRAPHIC INFORMATION AND MAJOR CUSTOMERS

The Company develops and licenses its rules-based software solutions and provides professional services, maintenance, and training related to its software. The Company derives substantially all of its revenue from the sale and support of one group of similar products and services software that provides business process solutions in the enterprise applications market. To assess performance, the Company s chief operating decision maker primarily reviews financial information on a consolidated basis. Therefore, the Company has determined it operates in one segment Business Process Solutions.

The Company s international revenue is from sales to customers based outside of the U.S. The Company derived its revenue from the following geographic areas:

(Dollars in thousands)	Three Months Ended June 30, 2012		2011		Six Months Ended June 30, 2012		2011	
U.S.	$ 61,239	58%	$ 59,411	57%	$ 116,931	54%	$ 111,323	54%
United Kingdom	18,329	18%	22,738	22%	36,467	17%	42,633	21%
Europe, other	12,686	12%	&nbs					