PEGASYSTEMS INC
Form 10-Q
August 09, 2012
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended 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.

PEGASYSTEMS INC.

Index to Form 10-Q

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.

Table of Contents

PEGASYSTEMS INC.

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(in thousands, except per share amounts)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	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.

Table of Contents

PEGASYSTEMS INC.

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(in thousands)

	Three Months Ended June 30,		Six Months Ended June 30,	
(in thousands)	**2012**	**2011**	**2012**	**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.

Table of Contents

PEGASYSTEMS INC.

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

	Six Months Ended June 30, 2012	Six Months Ended June 30, 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.

Table of Contents

PEGASYSTEMS INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. ACCOUNTING POLICIES

Basis of Presentation

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

Table of Contents

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.

Table of Contents

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)	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)	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.

Table of Contents

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:

(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
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

Table of Contents

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

Table of Contents

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:

(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
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.

Table of Contents

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%	10,956	11%	27,244	13%	31,453	15%
Other	12,802	12%	10,413	10%	35,581	16%	20,469	10%
	$ 105,056	100%	$ 103,518	100%	$ 216,223	100%	$ 205,878	100%

Table of Contents

The following table summarizes the Company s concentration of credit risk associated with customers accounting for 10% or more of the Company s total revenue and outstanding trade receivables.

	Three Months Ended June 30,		Six Months Ended June 30,	
(Dollars in thousands)	**2012**	**2011**	**2012**	**2011**
Total Revenue	**$ 105,056**	**$ 103,518**	**$ 216,223**	**$ 205,878**
Customer A	10%			

(Dollars in thousands)	**As of June 30, 2012**	**As of December 31, 2011**
Trade receivables, net of allowances	**$ 92,542**	**$ 98,293**
Customer A	10%	
Customer B		14%

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 the Private Securities Litigation Reform Act of 1995. These statements include, but are not limited to, statements about our future financial performance and business plans, the adequacy of our liquidity and capital resources, the continued payment of quarterly dividends by the Company, and the timing of recognizing revenue under existing term license agreements. 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-lo statements. These statements are not guarantees of future performance and involve certain risks, uncertainties and assumptions that are difficult to predict. Important factors that could cause actual future activities and results to differ include, among others, variation in demand for our products and services and the difficulty in predicting the completion of product acceptance and other factors affecting the timing of license revenue recognition, the ongoing uncertainty and volatility in the global financial markets related to the European sovereign debt crisis, the ongoing consolidation in the financial services and healthcare markets, reliance on third party relationships, the potential loss of vendor specific objective evidence for our professional services, and management of the Company s growth. These risks are described more completely in Item 1A of Part I of our Annual Report on Form 10-K for the year ended December 31, 2011 and in Item 1A of Part II of this Quarterly Report on Form 10-Q. We do not intend to update publicly any forward-looking statements, whether as a result of new information, future events or otherwise.

Business overview

We develop, market, license, and support software, which allows organizations to build, deploy, and change enterprise applications easily and quickly. Our unified software platform includes all the necessary elements and technologies to build enterprise applications in a fraction of the time it would take with competitive disjointed architectures, by directly capturing business objectives, automating programming, and automating work. Our customers use our software to improve their customer service and the customer experience, generate new business, and enhance productivity and profitability. We also provide professional services, maintenance, and training related to our software.

We focus our sales efforts on target accounts, which are large companies or divisions within companies and typically leaders in their industry. Our strategy is to sell a series of smaller licenses that are focused on specific purposes or areas of operations, rather than selling large enterprise licenses.

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 business process management (BPM) applications that unifies business rules and business processes. Our solution frameworks, built on the capabilities of PRPC, are purpose or industry-specific collections of best practice functionality, which allow organizations to quickly

Table of Contents

implement new customer-facing practices and processes, bring new offerings to market, and provide customized or specialized processing. Our products are simpler, easier to use and often result in shorter implementation periods than competitive enterprise software products. PRPC and related solution frameworks can be used by a broad range of customers within financial services, insurance, healthcare, communications, energy, and government markets.

Our solution frameworks products include customer relationship management (CRM) software, which enables unified predictive decisioning and analytics and optimizes the overall customer experience. Our decision management products and capabilities are designed to manage processes so that all actions optimize the outcome based on business objectives. We continue to invest in the development of new products and intend to remain a leader in BPM, CRM, and decision management.

We also offer Pega Cloud, a service offering that allows customers to create and/or run Pega applications using an Internet-based infrastructure. This offering enables our customers to immediately build, test, and deploy their applications in a secure cloud environment while minimizing their infrastructure and hardware costs. Revenue from our Pega Cloud offering is included in professional services revenue.

We offer training for our staff, customers, and partners at our regional training facilities, at third party facilities in numerous other locations, and at customer sites. Beginning in 2012, we offer training online through Pega Academy, which provides an alternative way to learn our software in a virtual environment quickly and easily. We expect that this online training will help expand the number of trained experts at a faster pace, but at a lower average price per class.

Our total revenue during the second quarter of 2012 was slightly higher compared to the same period in 2011. Our total revenue increased 5% during the first six months of 2012 compared to the first six months of 2011. License revenue decreased 11% and 2% during the second quarter and first six months of 2012, respectively, compared to the same periods in 2011. Maintenance revenue increased 22% during the second quarter of 2012 and 17% during the first six months of 2012 compared to the same periods in 2011 primarily due to the growth in the aggregate value of the installed base of our software. During the first six months of 2012, we generated approximately $12.5 million in cash from operations and ended the quarter with $102.9 million in cash, cash equivalents, and marketable securities.

We believe that the ongoing challenges for our business include our ability to drive revenue growth despite the deteriorating European economic conditions, expand our expertise in new and existing industries, remain a leader in CRM and the decision management market, and continue being the leader in the BPM market.

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 in our critical accounting policies as disclosed in our Annual Report on Form 10-K for the year ended December 31, 2011. 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, 2011.

Table of Contents

Results of Operations

(Dollars in thousands)	Three Months Ended June 30, 2012	Three Months Ended June 30, 2011	Increase (Decrease)		Six Months Ended June 30, 2012	Six Months Ended June 30, 2011	Increase (Decrease)	
Total revenue	$ 105,056	$ 103,518	$ 1,538	1%	$ 216,223	$ 205,878	$ 10,345	5%
Gross profit	$ 65,069	$ 63,121	$ 1,948	3%	$ 134,702	$ 125,465	$ 9,237	7%
Total operating expenses	$ 67,753	$ 59,887	$ 7,866	13%	$ 131,467	$ 116,667	$ 14,800	13%
(Loss) income from operations	$ (2,684)	$ 3,234	$ (5,918)	(183)%	$ 3,235	$ 8,798	$ (5,563)	(63)%
(Loss) income before (benefit) provision for income taxes	$ (3,168)	$ 3,331	$ (6,499)	(195)%	$ 2,763	$ 10,025	$ (7,262)	(72)%

The aggregate value of license arrangements executed during the second quarter and first six months of 2012 was significantly lower than in the same periods of 2011. The aggregate value of license arrangements executed fluctuates quarter to quarter. During the first six months of 2012 and 2011, approximately 67% and 52%, respectively, of license arrangements were executed with existing customers.

The increases in gross profit were primarily due to increases in maintenance revenue.

The increases in operating expenses were primarily due to the increases in selling and marketing and research and development expenses associated with higher headcount.

The decreases in income before provision for income taxes were primarily due to our operating expenses increasing faster than our revenue during the second quarter and first six months of 2012 compared to the same periods in 2011. During the first six months of 2012, the decrease was also due to a $1.2 million foreign currency transaction gain recorded in the first six months of 2011. See Note 4 Derivative Instruments in the notes to the accompanying unaudited condensed consolidated financial statements for further discussion.

Revenue

(Dollars in thousands)	Three Months Ended June 30, 2012		Three Months Ended June 30, 2011		Increase (Decrease)		Six Months Ended June 30, 2012		Six Months Ended June 30, 2011		Increase (Decrease)	
License revenue												
Perpetual licenses	$ 13,030	42%	$ 20,710	60%	$ (7,680)	(37)%	$ 33,449	50%	$ 44,281	65%	$ (10,832)	(24)%
Term licenses	9,169	30%	6,927	20%	2,242	32%	22,908	34%	16,818	25%	6,090	36%
Subscription	8,800	28%	7,008	20%	1,792	26%	10,585	16%	7,008	10%	3,577	51%
Total license revenue	$ 30,999	100%	$ 34,645	100%	$ (3,646)	(11)%	$ 66,942	100%	$ 68,107	100%	$ (1,165)	(2)%

A change in the mix between perpetual and term license arrangements executed in a period varies based on customer needs. This may cause our revenues to vary materially quarter to quarter as a higher proportion of term license arrangements would cause our license revenue to be recognized over longer periods. The mix shifted to a higher proportion of term licenses executed in the second quarter and first six months of 2012 compared to the same periods in 2011. As a result, perpetual license revenue decreased while the aggregate value of payments due under term licenses increased in the second quarter to $158.9 million from $154.2 million at the end of the first quarter of 2012. In addition, some of our perpetual license arrangements

Table of Contents

include extended payment terms and others include 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 $48.8 million as of June 30, 2012 compared to $44.7 million as of June 30, 2011. See the table of future cash receipts by year from these perpetual licenses and certain subscription licenses on page 23.

We recognize revenue for our term license arrangements over the term of the agreement as payments become due or earlier if prepaid. The increases in term license revenue were primarily due to the significant value of term license arrangements executed during the fourth quarter of 2011. As a result of the significant increase in new term license arrangements executed during 2011, the aggregate value of payments due under these term licenses grew to $158.9 million as of June 30, 2012 compared to $85.9 million as of June 30, 2011. The aggregate value of future payments due under non-cancellable term licenses as of June 30, 2012 includes $17.1 million of term license payments that we expect to recognize as revenue during the remainder of 2012. Our term license revenue for the remainder of 2012 could be higher than $17.1 million as we complete new term license agreements in 2012 or if we receive prepayments under existing term license agreements. See the table of future cash receipts by year from these term licenses on page 23.

Subscription revenue primarily consists of the ratable recognition of license, maintenance and bundled services revenue on perpetual license arrangements that include a right to unspecified future products. Subscription revenue does not include revenue from our Pega Cloud offerings. The timing of scheduled payments under customer arrangements may limit the amount of revenue that can be recognized in a reporting period. Consequently, our subscription revenue may vary quarter to quarter. The increases in subscription revenue were primarily due to the revenue recognized in the second quarter and first six months of 2012 on two arrangements for which revenue recognition criteria had not been met for the same periods in 2011.

	Three Months Ended June 30,		**Increase**		**Six Months Ended June 30,**		**Increase**	
(Dollars in thousands)	**2012**	**2011**			**2012**	**2011**		
Maintenance revenue								
Maintenance	$ 34,495	$ 28,294	$ 6,201	22%	$ 65,340	$ 55,742	$ 9,598	17%

The increases in maintenance revenue were primarily due to the growth in the aggregate value of the installed base of our software as well as the revenue recognition of a $2 million one-time fee associated with a customer maintenance agreement. As a result, we expect that maintenance revenue will be lower in the third quarter of 2012, but higher than in the first quarter of 2012.

	Three Months Ended June 30,				**Increase (Decrease)**		**Six Months Ended June 30,**				**Increase**	
(Dollars in thousands)	**2012**		**2011**				**2012**		**2011**			
Professional services revenue												
Consulting Services	$ 37,857	96%	$ 38,838	96%	$ (981)	(3)%	$ 80,276	96%	$ 78,567	96%	$ 1,709	2%
Training	1,705	4%	1,741	4%	(36)	(2)%	3,665	4%	3,462	4%	203	6%
Total Professional services	$ 39,562	100%	$ 40,579	100%	$ (1,017)	(3)%	$ 83,941	100%	$ 82,029	100%	$ 1,912	2%

Professional services are primarily consulting services related to new license implementations. The increase in consulting services revenue for the first six months of 2012 compared to the same period in 2011 was primarily due to the recognition of revenue on three large projects during the first quarter of 2012. The decrease in consulting services revenue during the second quarter of 2012 compared to the same period in 2011 was primarily due to the completion of work on several large time and material projects. Our consulting services revenue may fluctuate quarter to quarter based on customer operational requirements and budget availability, the number of license arrangements executed, and the mix of services performed by us or our enabled partners. We expect our consulting services revenue will be higher in the third quarter of 2012.

Table of Contents

(Dollars in thousands)	Three Months Ended June 30, 2012	Three Months Ended June 30, 2011	Increase (Decrease)		Six Months Ended June 30, 2012	Six Months Ended June 30, 2011	Increase	
Gross Profit								
Software license	$ 29,420	$ 33,014	$ (3,594)	(11)%	$ 63,764	$ 64,802	$ (1,038)	(2)%
Maintenance	30,777	25,034	5,743	23%	58,013	49,108	8,905	18%
Professional services	4,872	5,073	(201)	(4)%	12,925	11,555	1,370	12%
Total gross profit	$ 65,069	$ 63,121	$ 1,948	3%	$ 134,702	$ 125,465	$ 9,237	7%
Total gross profit %	62%	61%			62%	61%		
Software license gross profit %	95%	95%			95%	95%		
Maintenance gross profit %	89%	88%			89%	88%		
Professional services gross profit %	12%	13%			15%	14%		

Gross profit percent for each of software license, maintenance and professional services was consistent in the second quarter and first six months of 2012 compared to the same periods in 2011.

(Dollars in thousands)	Three Months Ended June 30, 2012	Three Months Ended June 30, 2011	Increase (Decrease)		Six Months Ended June 30, 2012	Six Months Ended June 30, 2011	Increase	
Amortization of intangibles:								
Cost of software license	$ 1,540	$ 1,571	$ (31)	(2)%	$ 3,108	$ 3,142	$ (34)	(1)%
Selling and marketing	1,232	1,232		%	2,464	2,464		%
General and Administrative	5	26	(21)	(81)%	10	93	(83)	(89)%
Total amortization expense	$ 2,777	$ 2,829	$ (52)	(2)%	$ 5,582	$ 5,699	$ (117)	(2)%

The decrease in amortization expense was due to the trade name intangible asset being fully amortized in 2011 and the technology designs intangible asset being fully amortized in the first quarter of 2012.

Operating expenses

(Dollars in thousands)	Three Months Ended June 30, 2012	Three Months Ended June 30, 2011	Increase		Six Months Ended June 30, 2012	Six Months Ended June 30, 2011	Increase	
Selling and marketing								
Selling and marketing	$ 41,188	$ 37,208	$ 3,980	11%	$ 79,583	$ 71,244	$ 8,339	12%
As a percent of total revenue	39%	36%			37%	35%		
Selling and marketing headcount at June 30					514	410	104	25%

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. Selling and marketing expenses also include the amortization of customer related intangibles.

We continue to create additional sales capacity by increasing sales headcount to target new accounts in existing industries, as well as to expand coverage in new industries and geographies. The increase in selling and marketing expenses during the second quarter of 2012 compared to the same period in 2011 was primarily due to a $6.2 million increase in compensation and benefit expenses associated with higher headcount, partially offset by a $2.4 million decrease in commission expense associated with the lower value of license arrangements executed in the second quarter of 2012 compared to the second quarter of 2011.

Table of Contents

The increase in selling and marketing expenses during the first six months of 2012 compared to the same period in 2011 was primarily due to a $10.1 million increase in compensation and benefit expenses associated with higher headcount, partially offset by a $2.1 million decrease in commission expense associated with the lower value of license arrangements executed during the first six months of 2012 compared to the same period in 2011.

(Dollars in thousands)	**Three Months Ended June 30, 2012**	**2011**	**Increase**		**Six Months Ended June 30, 2012**	**2011**	**Increase**	
Research and development								
Research and development	$ 18,901	$ 15,696	$ 3,205	20%	$ 37,905	$ 30,829	$ 7,076	23%
As a percent of total revenue	18%	15%			18%	15%		
Research and development headcount at June 30					599	423	176	42%

Research and development expenses include compensation, benefits, contracted services, and other headcount-related expenses associated with research and development. The increase in headcount reflects the growth in our Indian research facility. The increase in offshore headcount lowered our average compensation expense per employee.

The increases in research and development expenses during the second quarter and first six months of 2012 compared to the same periods in 2011 were primarily due to increases in compensation and benefit expenses associated with higher headcount of approximately $2 million and $4.6 million, respectively, and increases in rent and rent related expenses associated with the build-out of our world-wide facilities of $0.7 million and $1.6 million, respectively.

(Dollars in thousands)	**Three Months Ended June 30, 2012**	**2011**	**Increase**		**Six Months Ended June 30, 2012**	**2011**	**Increase**	
General and administrative								
General and administrative	$ 7,664	$ 6,839	$ 825	12%	$ 13,979	$ 13,971	$ 8	%
As a percent of total revenue	7%	7%			6%	7%		
General and administrative headcount at June 30					240	198	42	21%

General and administrative expenses include compensation, benefits, and other headcount-related expenses associated with 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 increase in general and administrative expenses during the second quarter of 2012 compared to the same period in 2011 was primarily due to a $0.9 million increase in compensation associated with higher headcount.

As a result of our lease arrangement for our new office headquarters, we expect to cease use of our current headquarter offices in the second half of 2012. Accordingly, in June 2011, we revised the remaining useful lives of certain leasehold improvements and furniture and fixtures and recorded incremental depreciation expense of approximately $0.1 million and $0.2 million during the second quarter and first six months of 2012, respectively. We recorded approximately $1.5 million and $3 million of rent expense under the new lease arrangement during the second quarter and first six months of 2012, respectively. For the second quarter of 2012, we recorded approximately $0.5 million of this rent and depreciation in cost of services and approximately $1.1 million in operating expenses. For the first six months of 2012, we recorded approximately $0.9 million of this rent and depreciation in cost of services and approximately $2.3 million in operating expenses.

Stock-based compensation

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

Table of Contents

(Dollars in thousands)	Three Months Ended June 30, 2012	Three Months Ended June 30, 2011	Increase (Decrease)		Six Months Ended June 30, 2012	Six Months Ended June 30, 2011	Increase	
Cost of services	$ 884	$ 553	$ 331	60%	$ 1,861	$ 1,350	$ 511	38%
Operating expenses	2,102	1,312	790	60%	3,977	3,050	927	30%
Total stock-based compensation before tax	2,986	1,865	1,121	60%	5,838	4,400	1,438	33%
Income tax benefit	(990)	(613)			(1,866)	(1,499)		

The increases in stock-based compensation expense during the second quarter and first six months of 2012 compared to the same periods in 2011 were primarily due to the higher value of the annual periodic equity grant and the timing of the annual board of directors equity grant, which for 2012 occurred in the second quarter of 2012, as compared to 2011, which occurred in the third quarter of 2011.

Non-operating income and expenses, net

(Dollars in thousands)	Three Months Ended June 30, 2012	Three Months Ended June 30, 2011	Change		Six Months Ended June 30, 2012	Six Months Ended June 30, 2011	Change	
Foreign currency transaction (loss) gain	$ (841)	$ 173	$ (1,014)	(586)%	$ (101)	$ 1,189	$ (1,290)	(108)%
Interest income, net	94	91	3	3%	205	177	28	16%
Other income (expense), net	263	(167)	430	(257)%	(576)	(139)	(437)	314%
Non-operating income (loss) and expenses, net	$ (484)	$ 97	$ (581)	(599)%	$ (472)	$ 1,227	$ (1,699)	(138)%

We hold foreign currency denominated accounts receivable and cash in our U.S. operating company where the functional currency is the U.S. dollar. As a result, these receivables and cash are subject to foreign currency transaction gains and losses when there are changes in exchange rates between the U.S. dollar and foreign currencies. The fluctuations in foreign currency transaction gains and losses were primarily due to the changes in the value of the British pound and Euro relative to the U.S. dollar during the second quarter and first six months of 2012 and 2011.

Beginning in the second quarter of 2011, we enter into forward foreign currency contracts to manage our exposure to changes in foreign currency exchange rates affecting the foreign currency denominated accounts receivable and cash held by our U.S. operating company. We have not designated these forward foreign currency contracts as hedging instruments and as a result, we record the fair value of the outstanding contracts at the end of the reporting period in our consolidated balance sheet, with any fluctuations in the value of these contracts recognized in other income (expense), net. The fluctuations in the value of these forward foreign currency contracts recorded in other income (expense), net, partially offset in net income 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 recorded in foreign currency transaction gain.

The total change in the fair value of our forward foreign currency contracts recorded in other income (expense), net, during the second quarter and first six months of 2012 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 total 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.

Provision for 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 of 2012 and 2011, we recorded a benefit of $0.9 million and a provision of $1.1 million, respectively, which resulted in an effective tax rate of 28.4% and 31.8%, respectively. During the first six months of 2012 and 2011, we recorded provisions of $1 million and $3 million, respectively, which resulted in an effective tax rate of 35.2% and 30.1%, respectively.

Table of Contents

Our effective tax rates were below the statutory federal income tax rate primarily due to the benefit related to the current period domestic production activities and the benefit from the SEZ India tax holiday.

Liquidity and capital resources

	Six Months Ended June 30,	
(in thousands)	**2012**	**2011**
Cash provided by (used in)		
Operating activities	$ 12,527	$ 17,220
Investing activities	(12,502)	(20,139)
Financing activities	(4,717)	(2,173)
Effect of exchange rate on cash	(834)	948
Net decrease in cash and cash equivalents	$ (5,526)	$ (4,144)

	As of June 30, 2012	As of December 31, 2011
Total cash, cash equivalents, and marketable securities	$ 102,864	$ 111,432

The decrease in cash, cash equivalents, and marketable securities was primarily due to lower net income.