

PEGASYSTEMS INC  
Form 10-Q  
November 12, 2013  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**Washington, D.C. 20549**

**FORM 10-Q**

**(Mark One)**

**Quarterly Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the quarterly period ended September 30, 2013**

**or**

**Transition Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_**

**Commission File Number: 1-11859**

**PEGASYSTEMS INC.**

*(Exact name of Registrant as specified in its charter)*

Massachusetts

04-2787865

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

*(IRS Employer  
Identification No.)*

One Rogers Street Cambridge, MA

02142-1209

*(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  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company

(Do not check if smaller reporting company)

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

There were 37,961,290 shares of the Registrant's common stock, \$.01 par value per share, outstanding on November 1, 2013.

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## PEGASYSTEMS INC.

## UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands)

|  | As of                 | As of                |
|--|-----------------------|----------------------|
|  | September 30,<br>2013 | December 31,<br>2012 |
| <b>ASSETS</b>  |                       |                      |
| Current assets:  |                       |                      |
| Cash and cash equivalents                                      | \$ 108,827            | \$ 77,525            |
| Marketable securities  | 79,618                | 45,460               |
| Total cash, cash equivalents, and marketable securities        | 188,445               | 122,985              |
| Trade accounts receivable, net of allowance of \$772 and \$963 | 90,583                | 134,066              |
| Deferred income taxes  | 10,152                | 10,202               |
| Income taxes receivable  | 4,199                 | 6,261                |
| Other current assets   | 6,929                 | 5,496                |
| Total current assets   | 300,308               | 279,010              |
| Property and equipment, net                                    | 28,977                | 30,827               |
| Long-term deferred income taxes                                | 49,693                | 49,292               |
| Long-term other assets   | 1,657                 | 1,680                |
| Intangible assets, net   | 49,910                | 58,232               |
| Goodwill   | 20,451                | 20,451               |
| Total assets   | \$ 450,996            | \$ 439,492           |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>                    |                       |                      |
| Current liabilities:   |                       |                      |
| Accounts payable   | \$ 2,347              | \$ 3,330             |
| Accrued expenses   | 20,741                | 15,534               |
| Accrued compensation and related expenses                      | 31,925                | 40,715               |
| Deferred revenue   | 91,758                | 95,546               |
| Total current liabilities                                      | 146,771               | 155,125              |
| Income taxes payable   | 13,748                | 13,551               |
| Long-term deferred revenue                                     | 17,954                | 18,719               |
| Other long-term liabilities                                    | 17,466                | 15,618               |
| Total liabilities  | 195,939               | 203,013              |
| Stockholders' equity:  |                       |                      |

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|   |            |            |
|---|------------|------------|
| Preferred stock, 1,000 shares authorized; no shares issued and outstanding                      |            |            |
| Common stock, 100,000 shares authorized; 37,989 shares and 37,945 shares issued and outstanding | 380        | 379        |
| Additional paid-in capital  | 138,271    | 138,576    |
| Retained earnings   | 113,410    | 94,349     |
| Accumulated other comprehensive income  | 2,996      | 3,175      |
| Total stockholders' equity  | 255,057    | 236,479    |
| Total liabilities and stockholders' equity  | \$ 450,996 | \$ 439,492 |

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)**

|  | <b>Three Months Ended</b> |                 | <b>Nine Months</b>   |                 |
|--|---------------------------|-----------------|----------------------|-----------------|
|  | <b>September 30,</b>      |                 | <b>Ended</b>         |                 |
|  | <b>2013</b>               | <b>2012</b>     | <b>September 30,</b> | <b>2012</b>     |
| <b>Revenue:</b>                          |                           |                 |                      |                 |
| Software license                         | \$ 44,802                 | \$ 28,575       | \$ 128,217           | \$ 95,517       |
| Maintenance                              | 37,979                    | 32,317          | 112,238              | 97,657          |
| Professional services                    | 39,230                    | 40,765          | 115,117              | 124,706         |
| <b>Total revenue</b>                     | <b>122,011</b>            | <b>101,657</b>  | <b>355,572</b>       | <b>317,880</b>  |
| <b>Cost of revenue:</b>                  |                           |                 |                      |                 |
| Software license                         | 1,592                     | 1,585           | 4,751                | 4,763           |
| Maintenance                              | 3,599                     | 3,745           | 11,106               | 11,072          |
| Professional services                    | 32,907                    | 32,335          | 97,772               | 103,351         |
| <b>Total cost of revenue</b>             | <b>38,098</b>             | <b>37,665</b>   | <b>113,629</b>       | <b>119,186</b>  |
| <b>Gross profit</b>                      | <b>83,913</b>             | <b>63,992</b>   | <b>241,943</b>       | <b>198,694</b>  |
| <b>Operating expenses:</b>               |                           |                 |                      |                 |
| Selling and marketing                    | 42,663                    | 36,893          | 127,279              | 116,476         |
| Research and development                 | 19,786                    | 19,506          | 59,123               | 57,411          |
| General and administrative               | 7,130                     | 7,192           | 21,203               | 21,171          |
| Acquisition-related costs                | 545                       |                 | 545                  |                 |
| <b>Total operating expenses</b>          | <b>70,124</b>             | <b>63,591</b>   | <b>208,150</b>       | <b>195,058</b>  |
| Income from operations                   | 13,789                    | 401             | 33,793               | 3,636           |
| Foreign currency transaction gain (loss) | 661                       | 438             | (1,666)              | 337             |
| Interest income, net                     | 123                       | 113             | 376                  | 318             |
| Other expense, net                       | (1,163)                   | (920)           | (418)                | (1,496)         |
| Income before provision for income taxes | 13,410                    | 32              | 32,085               | 2,795           |
| Provision for income taxes               | 4,700                     | 363             | 9,603                | 1,336           |
| <b>Net income (loss)</b>                 | <b>\$ 8,710</b>           | <b>\$ (331)</b> | <b>\$ 22,482</b>     | <b>\$ 1,459</b> |
| <b>Earnings (loss) per share:</b>        |                           |                 |                      |                 |
| Basic                                    | \$ 0.23                   | \$ (0.01)       | \$ 0.59              | \$ 0.04         |

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|  |         |           |         |         |
|--|---------|-----------|---------|---------|
| Diluted  | \$ 0.22 | \$ (0.01) | \$ 0.58 | \$ 0.04 |
| Weighted-average number of common shares outstanding |         |           |         |         |
| Basic  | 37,955  | 37,881    | 37,950  | 37,834  |
| Diluted  | 39,079  | 37,881    | 38,872  | 38,897  |
| Cash dividends declared per share                    | \$ 0.03 | \$ 0.03   | \$ 0.09 | \$ 0.09 |

See notes to unaudited condensed consolidated financial statements.

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## PEGASYSTEMS INC.

## UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(in thousands)

|  | Three Months Ended<br>September 30, |          | Nine Months Ended<br>September 30, |          |
|--|-------------------------------------|----------|------------------------------------|----------|
|  | 2013                                | 2012     | 2013                               | 2012     |
| Net income (loss)                                | \$ 8,710                            | \$ (331) | \$ 22,482                          | \$ 1,459 |
| Other comprehensive income (loss):               |                                     |          |                                    |          |
| Unrealized gain (loss) on securities, net of tax | 113                                 | 33       | (32)                               | 80       |
| Foreign currency translation adjustments         | 2,340                               | 1,315    | (147)                              | 1,248    |
| Total other comprehensive income (loss)          | 2,453                               | 1,348    | (179)                              | 1,328    |
| Comprehensive income                             | \$ 11,163                           | \$ 1,017 | \$ 22,303                          | \$ 2,787 |

See notes to unaudited condensed consolidated financial statements.



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

|  | <b>Nine Months Ended<br/>September 30,</b> |              |
|--|--|--------------|
|  | <b>2013</b>                                | <b>2012</b>  |
| <b>Operating activities:</b>   |  |              |
| Net income   | \$ 22,482                                  | \$ 1,459     |
| <b>Adjustments to reconcile net income to cash provided by operating activities:</b> |  |              |
| Excess tax benefits from exercise or vesting of equity awards                        | (2,670)                                    | (3,161)      |
| Deferred income taxes  | (537)                                      | (511)        |
| Depreciation and amortization  | 14,173                                     | 13,986       |
| Stock-based compensation expense   | 9,713                                      | 8,622        |
| Foreign currency transaction loss (gain)   | 1,666                                      | (337)        |
| Other non-cash items   | 2,736                                      | 4,021        |
| <b>Change in operating assets and liabilities:</b>                                   |  |              |
| Trade accounts receivable  | 42,611                                     | 18,938       |
| Income taxes receivable and other current assets                                     | 2,599                                      | (1,468)      |
| Accounts payable and accrued expenses  | (5,762)                                    | (20,491)     |
| Deferred revenue   | (3,836)                                    | 2,747        |
| Other long-term assets and liabilities   | 260  | 5,279        |
| <br>Cash provided by operating activities  | <br>83,435                                 | <br>29,084   |
| <b>Investing activities:</b>   |  |              |
| Purchase of marketable securities  | (56,645)                                   | (13,336)     |
| Matured and called marketable securities   | 21,129                                     | 18,465       |
| Investment in property and equipment   | (4,158)                                    | (21,875)     |
| <br>Cash used in investing activities  | <br>(39,674)                               | <br>(16,746) |
| <b>Financing activities:</b>   |  |              |
| Issuance of common stock for share-based compensation plans                          | 970  | 753          |
| Excess tax benefits from exercise or vesting of equity awards                        | 2,670                                      | 3,161        |
| Dividend payments to shareholders  | (2,281)                                    | (3,404)      |
| Common stock repurchases for tax withholdings for net settlement of equity awards    | (4,123)                                    | (3,650)      |
| Common stock repurchases under share repurchase programs                             | (9,178)                                    | (3,910)      |
| <br>Cash used in financing activities  | <br>(11,942)                               | <br>(7,050)  |
| <br>Effect of exchange rate on cash and cash equivalents                             | <br>(517)                                  | <br>596      |

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|  |            |           |
|--|------------|-----------|
| Net increase in cash and cash equivalents      | 31,302     | 5,884     |
| Cash and cash equivalents, beginning of period | 77,525     | 60,353    |
| Cash and cash equivalents, end of period       | \$ 108,827 | \$ 66,237 |

See notes to unaudited condensed consolidated financial statements.

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

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

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

*Acquisition-related costs*

Acquisition-related costs are expensed as incurred and include costs to affect an impending or completed acquisition and direct and incremental costs associated with an acquisition. During the third quarter of 2013, acquisition-related costs of \$0.5 million were primarily legal and advisory fees and due diligence costs associated with the Company's acquisition of Antenna Software, Inc. (Antenna). See Note 12 Subsequent Event.

**2. MARKETABLE SECURITIES**

| (in thousands)          | September 30, 2013 |                  |                   | Fair Value |
|-------------------------|--------------------|------------------|-------------------|------------|
|                         | Amortized Cost     | Unrealized Gains | Unrealized Losses |            |
| Municipal bonds         | \$ 47,325          | 60               | (28)              | \$ 47,357  |
| Corporate bonds         | 29,776             | 56               | (9)               | 29,823     |
| Certificates of deposit | 2,442              | 1                | (5)               | 2,438      |
|                         | \$ 79,543          | 117              | (42)              | \$ 79,618  |

| (in thousands) | December 31, 2012 |                  |                   | Fair Value |
|----------------|-------------------|------------------|-------------------|------------|
|                | Amortized Cost    | Unrealized Gains | Unrealized Losses |            |

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|                 |    |        |     |      |    |        |
|-----------------|----|--------|-----|------|----|--------|
| Municipal bonds | \$ | 30,488 | 48  | (10) | \$ | 30,526 |
| Corporate bonds |    | 14,853 | 83  | (2)  |    | 14,934 |
|                 | \$ | 45,341 | 131 | (12) | \$ | 45,460 |

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

As of September 30, 2013, remaining maturities of marketable debt securities ranged from October 2013 to February 2016, with a weighted-average remaining maturity of approximately 14 months.

**Table of Contents****3. DERIVATIVE INSTRUMENTS**

The Company uses foreign currency forward contracts ( forward contracts ) to manage its exposure to changes in foreign currency denominated accounts receivable, intercompany payables and cash primarily held by the U.S. operating company. The Company has been primarily exposed to the fluctuation in the British pound and Euro relative to the U.S. dollar. More recently, the Company has experienced increased levels of exposure to the Australian dollar and Indian rupee, for which it began to use forward contracts in the third quarter of 2013.

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

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

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

| Foreign currency (in thousands) | Notional Amount                     |          |                                    |          |
|---------------------------------|-------------------------------------|----------|------------------------------------|----------|
|                                 | Three Months Ended<br>September 30, |          | Nine Months Ended<br>September 30, |          |
|                                 | 2013                                | 2012     | 2013                               | 2012     |
| Euro                            | 28,500                              | 21,700   | 61,000                             | 48,900   |
| British pound                   | £ 26,000                            | £ 16,000 | £ 59,500                           | £ 39,000 |
| Australian dollar               | A\$ 15,500                          | A\$      | A\$ 15,500                         | A\$      |
| Indian rupee                    | Rs 460,000                          | Rs       | Rs 460,000                         | Rs       |

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

| (in thousands)                      | Change in Fair Value in USD         |          |                                    |            |
|-------------------------------------|-------------------------------------|----------|------------------------------------|------------|
|                                     | Three Months Ended<br>September 30, |          | Nine Months Ended<br>September 30, |            |
|                                     | 2013                                | 2012     | 2013                               | 2012       |
| Loss included in other expense, net | \$ (1,173)                          | \$ (926) | \$ (430)                           | \$ (1,522) |

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

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

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

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

| (in thousands)              | September 30,<br>2013 | Fair Value Measurements at Reporting<br>Date Using                            |   |
|-----------------------------|-----------------------|---|---|
|                             |                       | Quoted Prices<br>in Active<br>Markets<br>for<br>Identical Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) |
| Money market funds          | \$ 3,070              | \$ 3,070  | \$  |
| Marketable securities:      |                       |   |   |
| Municipal bonds             | \$ 47,357             | \$ 13,289   | \$ 34,068   |
| Corporate bonds             | 29,823                | 29,823  |   |
| Certificates of deposit     | 2,438                 |   | 2,438   |
| Total marketable securities | \$ 79,618             | \$ 43,112   | \$ 36,506   |
| (in thousands)              | December 31,          | Fair Value Measurements at Reporting<br>Date Using                            |   |
|                             |                       | Quoted Prices   | Significant   |

|                             | <b>2012</b> | <b>in Active<br/>Markets<br/>for<br/>Identical Assets<br/>(Level 1)</b> | <b>Other<br/>Observable<br/>Inputs<br/>(Level 2)</b> |
|-----------------------------|-------------|---|--|
| Money market funds          | \$ 2,873    | \$ 2,873  | \$   |
| Marketable securities:      |             |   |  |
| Municipal bonds             | \$ 30,526   | \$ 11,966   | \$ 18,560  |
| Corporate bonds             | 14,934      | 14,934  |  |
| Total marketable securities | \$ 45,460   | \$ 26,900   | \$ 18,560  |

Assets Measured at Fair Value on a Nonrecurring Basis

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

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

| (in thousands)                     | September 30,<br>2013 | December 31,<br>2012 |
|------------------------------------|-----------------------|----------------------|
| Trade accounts receivable          | \$ 58,037             | \$ 112,106           |
| Unbilled trade accounts receivable | 33,318                | 22,923               |
| <b>Total accounts receivable</b>   | <b>91,355</b>         | <b>135,029</b>       |
| Allowance for sales credit memos   | (772)                 | (963)                |
|                                    | <b>\$ 90,583</b>      | <b>\$ 134,066</b>    |

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 September 30, 2013 and December 31, 2012, respectively.

**6. GOODWILL AND OTHER INTANGIBLE ASSETS**

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

Intangible assets are recorded at cost and are amortized using the straight-line method over their estimated useful lives.

| (in thousands)                  | Range of<br>Useful Lives | Cost             | Accumulated<br>Amortization | Net Book<br>Value |
|---------------------------------|--------------------------|------------------|-----------------------------|-------------------|
| <b>As of September 30, 2013</b> |                          |                  |                             |                   |
| Customer related intangibles    | 9 years                  | \$ 44,355        | \$ (16,838)                 | \$ 27,517         |
| Technology                      | 4-9 years                | 43,446           | (21,053)                    | 22,393            |
| Other intangibles               | 1-5 years                | 2,238            | (2,238)                     |                   |
| <b>Total</b>                    |                          | <b>\$ 90,039</b> | <b>\$ (40,129)</b>          | <b>\$ 49,910</b>  |

| (in thousands)                 | Range of<br>Useful Lives | Cost             | Accumulated<br>Amortization | Net Book<br>Value |
|--------------------------------|--------------------------|------------------|-----------------------------|-------------------|
| <b>As of December 31, 2012</b> |                          |                  |                             |                   |
| Customer related intangibles   | 9 years                  | \$ 44,355        | \$ (13,142)                 | \$ 31,213         |
| Technology                     | 4-9 years                | 43,446           | (16,431)                    | 27,015            |
| Other intangibles              | 1-5 years                | 2,238            | (2,234)                     | 4                 |
| <b>Total</b>                   |                          | <b>\$ 90,039</b> | <b>\$ (31,807)</b>          | <b>\$ 58,232</b>  |



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For the third quarter and first nine months of 2013 and 2012, amortization of intangibles was reflected in the Company's unaudited condensed consolidated statements of operations as follows:

| (in thousands)             | Three Months Ended<br>September 30, |          | Nine Months Ended<br>September 30, |          |
|----------------------------|-------------------------------------|----------|------------------------------------|----------|
|                            | 2013                                | 2012     | 2013                               | 2012     |
| Cost of software license   | \$ 1,540                            | \$ 1,541 | \$ 4,622                           | \$ 4,649 |
| Selling and marketing      | 1,232                               | 1,232    | 3,696                              | 3,696    |
| General and administrative |                                     | 5        | 4                                  | 15       |
| Total amortization expense | \$ 2,772                            | \$ 2,778 | \$ 8,322                           | \$ 8,360 |

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

| <b>(in thousands) September 30, 2013</b> | <b>Future<br/>estimated<br/>amortization<br/>expense</b> |
|--|--|
| Remainder of 2013                        | \$ 2,773   |
| 2014                                     | 9,489  |
| 2015                                     | 8,688  |
| 2016                                     | 8,688  |
| 2017                                     | 8,688  |
| 2018 & thereafter                        | 11,584   |
|  | <b>\$ 49,910</b>   |

**7. ACCRUED EXPENSES**

| <b>(in thousands)</b>                   | <b>September 30,<br/>2013</b> | <b>December 31,<br/>2012</b> |
|---|-------------------------------|------------------------------|
| Partner commissions                     | \$ 4,349                      | \$ 1,723                     |
| Other taxes                             | 3,120                         | 2,711                        |
| Employee reimbursable expenses          | 2,255                         | 879                          |
| Dividends payable                       | 1,140                         |                              |
| Professional services contractor fees   | 1,660                         | 602                          |
| Self-insurance health and dental claims | 977                           | 1,707                        |
| Professional fees                       | 930                           | 811                          |
| Short-term deferred rent                | 783                           | 1,111                        |
| Foreign income taxes payable            | 649                           | 1,167                        |
| Acquisition-related costs               | 482                           |                              |
| Restructuring                           | 113                           | 441                          |
| Other                                   | 4,283                         | 4,382                        |
|   | <b>\$ 20,741</b>              | <b>\$ 15,534</b>             |

**8. DEFERRED REVENUE**

| <b>(in thousands)</b>           | <b>September 30,<br/>2013</b> | <b>December 31,<br/>2012</b> |
|---------------------------------|-------------------------------|------------------------------|
| Software license                | \$ 17,206                     | \$ 24,303                    |
| Maintenance                     | 63,342                        | 62,144                       |
| Professional services and other | 11,210                        | 9,099                        |

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|                                       |            |            |
|---------------------------------------|------------|------------|
| Current deferred revenue              | 91,758     | 95,546     |
| Software license                      | 16,690     | 15,407     |
| Maintenance and professional services | 1,264      | 3,312      |
| Long-term deferred revenue            | 17,954     | 18,719     |
|                                       | \$ 109,712 | \$ 114,265 |

**Table of Contents****9. STOCK-BASED COMPENSATION**

For the third quarter and first nine months of 2013 and 2012, stock-based compensation expense was reflected in the Company's unaudited condensed consolidated statements of operations as follows:

| (in thousands)                            | Three Months Ended<br>September 30, |          | Nine Months Ended<br>September 30, |          |
|---|-------------------------------------|----------|------------------------------------|----------|
|   | 2013                                | 2012     | 2013                               | 2012     |
| Cost of services                          | \$ 947                              | \$ 849   | \$ 3,134                           | \$ 2,710 |
| Operating expenses                        | 2,053                               | 1,935    | 6,579                              | 5,912    |
| Total stock-based compensation before tax | \$ 3,000                            | \$ 2,784 | \$ 9,713                           | \$ 8,622 |
| Income tax benefit                        | (893)                               | (915)    | (2,941)                            | (2,781)  |

During the first nine months of 2013, the Company issued approximately 344,000 shares to its employees and 14,000 shares to its non-employee directors under the Company's share-based compensation plans.

During the first nine months of 2013, the Company granted approximately 114,000 restricted stock units ( RSUs ) with a total fair value of approximately \$3.3 million. Approximately 59,000 RSUs were issued in connection with the election by employees to receive 50% of their 2013 target incentive compensation under the Company's Corporate Incentive Compensation Plan (the CICP ) in the form of RSUs instead of cash. Stock-based compensation of approximately \$1.7 million associated with this RSU grant will be recognized over a one-year period beginning on the grant date.

As of September 30, 2013, the Company had approximately \$12.2 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****10. EARNINGS PER SHARE**

Basic earnings per share is computed using the weighted-average number of common shares outstanding during the applicable period. Diluted earnings per share is computed using the weighted-average number of common shares outstanding during the applicable period, plus the dilutive effect of outstanding options, RSUs, and warrants, using the treasury stock method and the average market price of the Company's common stock during the applicable period. Certain shares related to some of the Company's 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</b>     |             | <b>Nine Months Ended</b>      |             |
|---|-------------------------------|-------------|-------------------------------|-------------|
|   | <b>September 30,<br/>2013</b> | <b>2012</b> | <b>September 30,<br/>2013</b> | <b>2012</b> |
| <b>Basic</b>  |                               |             |                               |             |
| Net income (loss)   | \$ 8,710                      | \$ (331)    | \$ 22,482                     | \$ 1,459    |
| Weighted-average common shares outstanding                            | 37,955                        | 37,881      | 37,950                        | 37,834      |
| Earnings (loss) per share, basic                                      | \$ 0.23                       | \$ (0.01)   | \$ 0.59                       | \$ 0.04     |
| <b>Diluted</b>  |                               |             |                               |             |
| Net income (loss)   | \$ 8,710                      | \$ (331)    | \$ 22,482                     | \$ 1,459    |
| Weighted-average common shares outstanding, basic                     | 37,955                        | 37,881      | 37,950                        | 37,834      |
| Weighted-average effect of dilutive securities:                       |                               |             |                               |             |
| Stock options and warrants  | 913                           |             | 729                           | 817         |
| RSUs  | 211                           |             | 193                           | 246         |
| Effect of assumed exercise of stock options, warrants and RSUs        | 1,124                         |             | 922                           | 1,063       |
| Weighted-average common shares outstanding, diluted                   | 39,079                        | 37,881      | 38,872                        | 38,897      |
| Earnings (loss) per share, diluted                                    | \$ 0.22                       | \$ (0.01)   | \$ 0.58                       | \$ 0.04     |
| Outstanding options and RSUs excluded as impact would be antidilutive | 33                            | 1,865       | 146                           | 55          |

**Table of Contents****11. GEOGRAPHIC INFORMATION AND MAJOR CLIENTS**

The Company develops and licenses its rules-based software solutions and provides professional and cloud 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 clients based outside of the U.S. The Company derived its revenue from the following geographic areas:

| <i>(Dollars in thousands)</i> | <b>Three Months Ended<br/>September 30,</b> |      |             |      | <b>Nine Months Ended<br/>September 30,</b> |      |             |      |
|-------------------------------|---|------|-------------|------|--|------|-------------|------|
|                               | <b>2013</b>                                 |      | <b>2012</b> |      | <b>2013</b>                                |      | <b>2012</b> |      |
| U.S.                          | \$ 59,034                                   | 49%  | \$ 56,475   | 56%  | \$ 189,489                                 | 53%  | \$ 173,406  | 55%  |
| United Kingdom                | 22,115                                      | 18%  | 18,862      | 18%  | 58,782                                     | 17%  | 55,329      | 17%  |
| Europe, other                 | 24,748                                      | 20%  | 12,836      | 13%  | 66,012                                     | 18%  | 45,051      | 14%  |
| Other                         | 16,114                                      | 13%  | 13,484      | 13%  | 41,289                                     | 12%  | 44,094      | 14%  |
|                               | \$ 122,011                                  | 100% | \$ 101,657  | 100% | \$ 355,572                                 | 100% | \$ 317,880  | 100% |

Clients accounting for 10% or more of the Company’s total revenue or outstanding trade receivables, net, were as follows:

| <i>(Dollars in thousands)</i> | <b>Three Months Ended<br/>September 30,</b> |                   | <b>Nine Months Ended<br/>September 30,</b> |                   |
|-------------------------------|---|-------------------|--|-------------------|
|                               | <b>2013</b>                                 | <b>2012</b>       | <b>2013</b>                                | <b>2012</b>       |
| <b>Total revenue</b>          | <b>\$ 122,011</b>                           | <b>\$ 101,657</b> | <b>\$ 355,572</b>                          | <b>\$ 317,880</b> |
| Client A                      | 10%   | %                 | %  | %                 |

| <i>(Dollars in thousands)</i>              | <b>As of<br/>September 30,<br/>2013</b> | <b>As of<br/>December 31,<br/>2012</b> |
|--|---|--|
| <b>Trade receivables, net of allowance</b> | <b>\$ 90,583</b>                        | <b>\$ 134,066</b>                      |

Client A

13%

10%

**12. SUBSEQUENT EVENT**

On October 9, 2013, the Company acquired Antenna, a leading provider of mobile application development platforms. The Company acquired all of the outstanding capital stock of Antenna in a merger for \$26.3 million in cash. The Company is in the process of preparing an allocation of the purchase price to the fair value of assets acquired and liabilities assumed, but currently expects that a substantial portion of the Antenna purchase price will ultimately be allocated to intangible assets, and that such assets are likely to include acquired core technology, customer related assets and goodwill. During the third quarter of 2013, the Company incurred direct and incremental expenses associated with the transaction of \$0.5 million and expects to incur an additional estimated \$2.2 million of such expenses that are primarily professional fees to affect the acquisition.

The Company believes the acquisition will offer its collective clients faster time-to-market and increased flexibility in end-to-end mobile application development, powerful device management and cloud-based mobile Backend-as-a-Service.

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### **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 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. 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, 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, 2012 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 enables our clients 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. We also provide consulting services, cloud service offerings, 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 licenses that are focused on a specific purpose or area of operations, rather than to sell a large enterprise license.

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 implement new client-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 clients across markets including financial services, insurance, healthcare, communications, life sciences, energy and government.

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 our clients to immediately build, test, and deploy their Pega applications in a secure cloud environment while minimizing their infrastructure and hardware costs. Revenue from our Pega Cloud offering is included in consulting services revenue.

We offer training for our staff, clients, and partners at our regional training facilities, at third party facilities, and at client sites. We also offer training online through Pega Academy, which provides an alternative way to learn our software in a virtual environment quickly and easily. We believe that this online training will continue to expand the number of trained experts at a faster pace.

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On October 9, 2013, we acquired Antenna Software, Inc. ( Antenna ), a leading provider of mobile application development platforms for \$26.3 million in cash. We believe the acquisition will offer our collective clients faster time-to-market and increased flexibility in end-to-end mobile application development, powerful device management and cloud-based mobile Backend-as-a-Service.

**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, 2012. 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, Significant Judgments 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, 2012.

**Results of Operations**

|  | Three Months Ended |            | Increase  |     | Nine Months Ended |            | Increase  |      |
|--|--------------------|------------|-----------|-----|-------------------|------------|-----------|------|
|  | September 30,      |            |           |     | September 30,     |            |           |      |
| (Dollars in thousands)                   | 2013               | 2012       |           |     | 2013              | 2012       |           |      |
| Total revenue                            | \$ 122,011         | \$ 101,657 | \$ 20,354 | 20% | \$ 355,572        | \$ 317,880 | \$ 37,692 | 12%  |
| Gross profit                             | \$ 83,913          | \$ 63,992  | \$ 19,921 | 31% | \$ 241,943        | \$ 198,694 | \$ 43,249 | 22%  |
| Total operating expenses                 | \$ 70,124          | \$ 63,591  | \$ 6,533  | 10% | \$ 208,150        | \$ 195,058 | \$ 13,092 | 7%   |
| Income from operations                   | \$ 13,789          | \$ 401     | \$ 13,388 | n/m | \$ 33,793         | \$ 3,636   | \$ 30,157 | 829% |
| Income before provision for income taxes | \$ 13,410          | \$ 32      | \$ 13,378 | n/m | \$ 32,085         | \$ 2,795   | \$ 29,290 | n/m  |

n/m - not meaningful

**Revenue**

| Three Months Ended | Increase   | Nine Months Ended | Increase   |
|--------------------|------------|-------------------|------------|
| September 30,      | (Decrease) | September 30,     | (Decrease) |

| <i>llars in<br/>sands)</i> | <b>2013</b> |      | <b>2012</b> |      | <b>2013</b> |           | <b>2012</b> |           |           |           |           |
|----------------------------|-------------|------|-------------|------|-------------|-----------|-------------|-----------|-----------|-----------|-----------|
| <i>nse<br/>nue</i>         |             |      |             |      |             |           |             |           |           |           |           |
| etual                      |             |      |             |      |             |           |             |           |           |           |           |
| ses                        | \$ 28,971   | 65%  | \$ 16,999   | 60%  | \$ 11,972   | \$ 79,978 | 62%         | \$ 50,448 | 53%       | \$ 29,530 |           |
| n                          |             |      |             |      |             |           |             |           |           |           |           |
| ses                        | 14,077      | 31%  | 9,742       | 34%  | 4,335       | 42,987    | 34%         | 32,650    | 34%       | 10,337    |           |
| scription                  | 1,754       | 4%   | 1,834       | 6%   | (80)        | 5,252     | 4%          | 12,419    | 13%       | (7,167)   |           |
| l license                  |             |      |             |      |             |           |             |           |           |           |           |
| nue                        | \$ 44,802   | 100% | \$ 28,575   | 100% | \$ 16,227   | 57%       | \$ 128,217  | 100%      | \$ 95,517 | 100%      | \$ 32,700 |

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The aggregate value of new license arrangements executed during the third quarter of 2013 nearly doubled as compared to the third quarter of 2012 due to a higher average value of license arrangements executed in the third quarter of 2013. The aggregate value of new license arrangements executed during the first nine months of 2013 was higher than in the same period in 2012 due to both a larger number and higher average value of license arrangements executed in the first nine months of 2013. The aggregate value of new license arrangements executed fluctuates quarter to quarter. During the first nine months of 2013 and 2012, approximately 72% and 68%, respectively, of the value of new license arrangements were executed with existing clients.

The mix between perpetual and term license arrangements executed in a particular period varies based on client needs. A change in the mix between perpetual and term license arrangements executed may cause our revenues to vary materially from period to period. A higher proportion of term license arrangements executed would result in more license revenue being recognized over longer periods as payments become due or earlier if prepaid. However, some of our perpetual license arrangements include extended payment terms or additional rights of use, which also result in the recognition of revenue over longer periods.

The increase in perpetual license revenue during the third quarter of 2013 compared to the same period in 2012 was primarily due to larger value perpetual arrangements executed during the third quarter of 2013 than in the third quarter of 2012. The increase in perpetual license revenue during the first nine months of 2013 compared to the same period in 2012 was primarily due to higher value perpetual arrangements executed during the first nine months of 2013 and the fourth quarter of 2012 than during the first nine months of 2012 and the fourth quarter of 2011.

The increases in term license revenue were primarily due to revenue recognized on term license arrangements executed in 2012 and 2011. The aggregate value of payments due under noncancellable term licenses grew to \$203.6 million as of September 30, 2013 compared to \$155.9 million as of September 30, 2012. We expect to recognize \$16 million of the \$203.6 million as revenue during the remainder of 2013 in addition to new term license agreements we may complete or prepayments we may receive from existing term license agreements. See the table of future cash receipts on page 22.

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, which is included in consulting services. The timing of scheduled payments under client arrangements may limit the amount of revenue recognized in a reporting period. Consequently, our subscription revenue may vary quarter to quarter. The decrease in subscription revenue during the first nine months of 2013 compared to the same period in 2012 was primarily due to revenue recognized in the second quarter of 2012 for a large payment that became due.

|                            | Three Months Ended |           | Increase |     | Nine Months Ended |           | Increase  |     |
|----------------------------|--------------------|-----------|----------|-----|-------------------|-----------|-----------|-----|
|                            | September 30,      |           |          |     | September 30,     |           |           |     |
| (Dollars in thousands)     | 2013               | 2012      |          |     | 2013              | 2012      |           |     |
| <b>Maintenance revenue</b> |                    |           |          |     |                   |           |           |     |
| Maintenance                | \$ 37,979          | \$ 32,317 | \$ 5,662 | 18% | \$ 112,238        | \$ 97,657 | \$ 14,581 | 15% |

The increases in maintenance revenue were primarily due to the growth in the aggregate value of the installed base of our software.

|                         | Three Months Ended<br>September 30, |      |           |      | (Decrease) |      | Nine Months Ended<br>September 30, |      |            |      | (Decrease) |       |
|-------------------------|-------------------------------------|------|-----------|------|------------|------|------------------------------------|------|------------|------|------------|-------|
|                         | 2013                                | 2012 |           |      |            |      | 2013                               | 2012 |            |      |            |       |
| lars in<br>(sands)      |                                     |      |           |      |            |      |                                    |      |            |      |            |       |
| essional<br>ices<br>nue |                                     |      |           |      |            |      |                                    |      |            |      |            |       |
| ulting                  |                                     |      |           |      |            |      |                                    |      |            |      |            |       |
| ices                    | \$ 38,097                           | 97%  | \$ 39,549 | 97%  | \$ (1,452) | (4)% | \$ 111,272                         | 97%  | \$ 119,825 | 96%  | \$ (8,553) | (7)%  |
| ing                     | 1,133                               | 3%   | 1,216     | 3%   | (83)       | (7)% | 3,845                              | 3%   | 4,881      | 4%   | (1,036)    | (21)% |
| l                       |                                     |      |           |      |            |      |                                    |      |            |      |            |       |
| essional<br>ices        | \$ 39,230                           | 100% | \$ 40,765 | 100% | \$ (1,535) | (4)% | \$ 115,117                         | 100% | \$ 124,706 | 100% | \$ (9,589) | (8)%  |

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Consulting services includes revenue from our Pega Cloud offerings. The decreases in consulting services revenue were primarily the result of more clients becoming enabled and our partners leading more implementation projects. If this trend continues, our consulting services revenue may continue to decrease in future periods. The decrease in our training revenue during the first nine months of 2013 compared to the same period in 2012 was primarily due to the increased adoption of our Pega Academy self-service online training by our partners, which has a lower average price per student.

**Gross profit**

| <i>(Dollars in thousands)</i>        | Three Months Ended<br>September 30, |                  | Increase (Decrease) |            | Nine Months Ended<br>September 30, |                   | Increase (Decrease) |            |
|--------------------------------------|-------------------------------------|------------------|---------------------|------------|------------------------------------|-------------------|---------------------|------------|
|                                      | 2013                                | 2012             |                     |            | 2013                               | 2012              |                     |            |
| <b>Gross Profit</b>                  |                                     |                  |                     |            |                                    |                   |                     |            |
| Software license                     | \$ 43,210                           | \$ 26,990        | \$ 16,220           | 60%        | \$ 123,466                         | \$ 90,754         | \$ 32,712           | 36%        |
| Maintenance                          | 34,380                              | 28,572           | 5,808               | 20%        | 101,132                            | 86,585            | 14,547              | 17%        |
| Professional services                | 6,323                               | 8,430            | (2,107)             | (25)%      | 17,345                             | 21,355            | (4,010)             | (19)%      |
| <b>Total gross profit</b>            | <b>\$ 83,913</b>                    | <b>\$ 63,992</b> | <b>\$ 19,921</b>    | <b>31%</b> | <b>\$ 241,943</b>                  | <b>\$ 198,694</b> | <b>\$ 43,249</b>    | <b>22%</b> |
| Total gross profit %                 | 69%                                 | 63%              |                     |            | 68%                                | 63%               |                     |            |
| Software license gross profit %      | 96%                                 | 94%              |                     |            | 96%                                | 95%               |                     |            |
| Maintenance gross profit %           | 91%                                 | 88%              |                     |            | 90%                                | 89%               |                     |            |
| Professional services gross profit % | 16%                                 | 21%              |                     |            | 15%                                | 17%               |                     |            |

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

The decreases in professional services gross profit percent were primarily due to lower consulting revenues, costs incurred on several projects for which the corresponding revenue will be recognized in future periods as revenue recognition criteria had not been met, and an increase in employee incentive expenses.

**Operating expenses**

| <i>(Dollars in thousands)</i>                    | Three Months Ended<br>September 30, |           | Increase |     | Nine Months Ended<br>September 30, |            | Increase  |    |
|--|-------------------------------------|-----------|----------|-----|------------------------------------|------------|-----------|----|
|  | 2013                                | 2012      |          |     | 2013                               | 2012       |           |    |
| <b>Selling and marketing</b>                     |                                     |           |          |     |                                    |            |           |    |
| Selling and marketing                            | \$ 42,663                           | \$ 36,893 | \$ 5,770 | 16% | \$ 127,279                         | \$ 116,476 | \$ 10,803 | 9% |
| As a percent of total revenue                    | 35%                                 | 36%       |          |     | 36%                                | 37%        |           |    |
| Selling and marketing headcount at September 30, |                                     |           |          |     | 538                                | 524        | 14        | 3% |

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.

The increase in selling and marketing expenses during the third quarter of 2013 compared to the same period in 2012 was primarily due to a \$2.2 million increase in compensation expenses, a \$1.4 million increase in commission expense associated with the higher value of new license arrangements executed, and a \$2.7 million increase in partner commission expense.

The increase in selling and marketing expenses during the first nine months of 2013 compared to the same period in 2012 was primarily due to a \$5.5 million increase in compensation expenses, a \$2.2 million increase in commission expense associated with the higher value of new license arrangements executed and a \$2.8 million increase in partner commission expense.

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| <i>(Dollars in thousands)</i>   | <b>Three Months Ended</b> |             | <b>Increase</b> |    | <b>Nine Months Ended</b> |             | <b>Increase</b> |     |
|---|---------------------------|-------------|-----------------|----|--------------------------|-------------|-----------------|-----|
|   | <b>September 30,</b>      |             |                 |    | <b>September 30,</b>     |             |                 |     |
|   | <b>2013</b>               | <b>2012</b> |                 |    | <b>2013</b>              | <b>2012</b> |                 |     |
| <b>Research and development</b>   |                           |             |                 |    |                          |             |                 |     |
| Research and development  | \$ 19,786                 | \$ 19,506   | \$ 280          | 1% | \$ 59,123                | \$ 57,411   | \$ 1,712        | 3%  |
| As a percent of total revenue   | 16%                       | 19%         |                 |    | 17%                      | 18%         |                 |     |
| Research and development headcount at September 30,   |                           |             |                 |    | 817                      | 713         | 104             | 15% |
| 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 India research facility as we have been replacing contractors with employees. The increase in offshore headcount lowered our average compensation expense per employee.

The increase in research and development expenses during the third quarter of 2013 compared to the same period in 2012 was primarily due to a \$1.3 million increase in compensation expenses associated with higher headcount, partially offset by a \$0.8 million decrease in rent and equipment-related expenses.

The increase in research and development expenses during the first nine months of 2013 compared to the same period in 2012 was primarily due to a \$5.5 million increase in compensation and benefit expenses associated with higher headcount, partially offset by a \$2.3 million decrease in contractor expenses associated with our hiring of employees to replace contractors, and a \$1.9 million decrease in rent and equipment-related expenses.

| <i>(Dollars in thousands)</i>  | <b>Three Months Ended</b> |             | <b>(Decrease)</b> |      | <b>Nine Months Ended</b> |             | <b>Increase</b> |    |
|--|---------------------------|-------------|-------------------|------|--------------------------|-------------|-----------------|----|
|  | <b>September 30,</b>      |             |                   |      | <b>September 30,</b>     |             |                 |    |
|  | <b>2013</b>               | <b>2012</b> |                   |      | <b>2013</b>              | <b>2012</b> |                 |    |
| <b>General and administrative</b>  |                           |             |                   |      |                          |             |                 |    |
| General and administrative   | \$ 7,130                  | \$ 7,192    | \$ (62)           | (1)% | \$ 21,203                | \$ 21,171   | \$ 32           | %  |
| As a percent of total revenue  | 6%                        | 7%          |                   |      | 6%                       | 7%          |                 |    |
| General and administrative headcount at September 30,  |                           |             |                   |      | 248                      | 243         | 5               | 2% |
| 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 our other functional departments. |                           |             |                   |      |                          |             |                 |    |

**Stock-based compensation**



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

| <i>(Dollars in thousands)</i>                    | <b>Three Months Ended</b> |                      | <b>Increase</b> |           | <b>Nine Months Ended</b> |                      | <b>Increase</b> |            |
|--|---------------------------|----------------------|-----------------|-----------|--------------------------|----------------------|-----------------|------------|
|  | <b>September 30,</b>      | <b>September 30,</b> |                 |           | <b>September 30,</b>     | <b>September 30,</b> |                 |            |
|  | <b>2013</b>               | <b>2012</b>          |                 |           | <b>2013</b>              | <b>2012</b>          |                 |            |
| Cost of services                                 | \$ 947                    | \$ 849               | \$ 98           | 12%       | \$ 3,134                 | \$ 2,710             | \$ 424          | 16%        |
| Operating expenses                               | 2,053                     | 1,935                | 118             | 6%        | 6,579                    | 5,912                | 667             | 11%        |
| <b>Total stock-based compensation before tax</b> | <b>3,000</b>              | <b>2,784</b>         | <b>216</b>      | <b>8%</b> | <b>9,713</b>             | <b>8,622</b>         | <b>1,091</b>    | <b>13%</b> |
| Income tax benefit                               | (893)                     | (915)                |                 |           | (2,941)                  | (2,781)              |                 |            |

The increases in stock-based compensation expense were primarily due to the higher value of the annual periodic equity grant, partially offset by a lower value of new hire equity awards.

**Table of Contents*****Non-operating income and expenses, net***

| <i>(Dollars in thousands)</i>            | <b>Three Months Ended</b> |             |               |     | <b>Nine Months Ended</b> |             |               |        |
|--|---------------------------|-------------|---------------|-----|--------------------------|-------------|---------------|--------|
|  | <b>September 30,</b>      |             | <b>Change</b> |     | <b>September 30,</b>     |             | <b>Change</b> |        |
|  | <b>2013</b>               | <b>2012</b> |               |     | <b>2013</b>              | <b>2012</b> |               |        |
| Foreign currency transaction gain (loss) | \$ 661                    | \$ 438      | \$ 223        | 51% | \$ (1,666)               | \$ 337      | \$ (2,003)    | (594)% |
| Interest income, net                     | 123                       | 113         | 10            | 9%  | 376                      | 318         | 58            | 18%    |
| Other expense, net                       | (1,163)                   | (920)       | (243)         | 26% | (418)                    | (1,496)     | 1,078         | (72)%  |
| Non-operating loss                       | \$ (379)                  | \$ (369)    | \$ (10)       | 3%  | \$ (1,708)               | \$ (841)    | \$ (867)      | 103%   |

We use forward contracts to manage our exposure to changes in foreign currency denominated accounts receivable, intercompany payables, and cash primarily held by our U.S. operating company. We have not designated these forward 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 expense, net. The fluctuations in the value of these forward contracts recorded in other expense, net, partially offset in net income, the gains and losses from the remeasurement or settlement of the foreign currency denominated accounts receivable, intercompany payables, and cash held by the U.S. operating company recorded in foreign currency transaction loss.

We have been primarily exposed to the fluctuation in the British pound and Euro relative to the U.S. dollar. More recently, we have experienced increased levels of exposure to the Australian dollar and Indian rupee. See Note 3

Derivative Instruments in the notes to the accompanying unaudited condensed consolidated financial statements for discussion on our use of forward contracts.

The total change in the fair value of our forward contracts recorded in other expense, net, during the third quarter and first nine months of 2013 was a loss of \$1.2 million and \$0.4 million, respectively. The total change in the fair value of our foreign currency forward contracts recorded in other expense, net, during the third quarter and first nine months of 2012 was a loss of \$0.9 million and \$1.5 million, respectively.

***Provision for income taxes***

We account for income taxes at each interim period using our estimated annual effective tax rate and adjust for discrete tax items recorded in the same period. The provision for income taxes represents current and future amounts owed for federal, state, and foreign taxes. During the third quarter of 2013 and 2012, we recorded a tax provision of \$4.7 million and \$0.4 million, respectively. During the first nine months of 2013 and 2012, we recorded a tax provision of \$9.6 million and \$1.3 million, on pre-tax income of \$32.1 million and \$2.8 million, respectively, which resulted in an effective tax rate of 29.9% and 47.8%, respectively. Our effective tax rate for the first nine months of 2013 was below the statutory rate primarily due to the domestic production activities deduction, our foreign tax rate

differential benefit, and a \$0.8 million tax benefit related to our 2012 research and experimentation credit recognized in the first quarter of 2013 as a result of the American Taxpayer Relief Act of 2012 that was signed into law in January 2013. Our effective tax rate for the first nine months of 2012 was a result of low pre-tax income and certain discrete items that were recorded in 2012.

**Table of Contents****Liquidity and capital resources**

| <i>(in thousands)</i>                                   | <b>Nine Months Ended</b>      |                               |
|---|-------------------------------|-------------------------------|
|   | <b>September 30,<br/>2013</b> | <b>September 30,<br/>2012</b> |
| Cash provided by (used in):                             |                               |                               |
| Operating activities                                    | \$ 83,435                     | \$ 29,084                     |
| Investing activities                                    | (39,674)                      | (16,746)                      |
| Financing activities                                    | (11,942)                      | (7,050)                       |
| Effect of exchange rate on cash                         | (517)                         | 596                           |
| Net increase in cash and cash equivalents               | \$ 31,302                     | \$ 5,884                      |
|   | <b>As of</b>                  | <b>As of</b>                  |
|   | <b>September 30,<br/>2013</b> | <b>December 31,<br/>2012</b>  |
| Total cash, cash equivalents, and marketable securities | \$ 188,445                    | \$ 122,985                    |

The increase in cash and cash equivalents was primarily due to the significant increase in cash provided by operating activities associated with our strong accounts receivable collections during the first nine months of 2013, which were generated from our significant arrangements executed in the fourth quarter of 2012. We believe that our current cash, cash equivalents, and cash flow from operations will be sufficient to fund our operations, our dividend payments and our share repurchase program for at least the next 12 months.

We evaluate acquisition opportunities from time to time, which if pursued, could require use of our funds. On October 9, 2013, we acquired Antenna for \$26.3 million in cash. During the third quarter of 2013, we incurred direct and incremental expenses associated with the transaction of \$0.5 million and expect to incur an additional estimated \$2.2 million of such expenses that are primarily professional fees to affect the acquisition.

As of September 30, 2013, approximately \$54.8 million of our cash and cash equivalents was held in our foreign subsidiaries. If it becomes necessary to repatriate these funds, we may be required to pay U.S. tax, net of any applicable foreign tax credits, upon repatriation. We consider the earnings of our foreign subsidiaries to be permanently reinvested and, as a result, U.S. taxes on such earnings are not provided. It is impractical to estimate the amount of U.S. tax we could have to pay upon repatriation due to the complexity of the foreign tax credit calculations and because we consider our earnings permanently reinvested. There can be no assurance that changes in our plans or other events affecting our operations will not result in materially accelerated or unexpected expenditures.

**Cash provided by operating activities**

The primary drivers of cash provided by operating activities during the first nine months of 2013 were net income of \$22.5 million and a \$42.6 million decrease in accounts receivable due to our significant collections.

The primary drivers of cash provided by operating activities during the first nine months of 2012 were net income of \$1.5 million, an \$18.9 million decrease in account receivable due to higher collections, and a \$2.7 million increase in deferred revenue.

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

Total contractual future cash receipts due from our existing license agreements was approximately \$234.2 million as of September 30, 2013 compared to \$195.2 million as of September 30, 2012. The future cash receipts due as of September 30, 2013 are summarized as follows:

| <b>As of September 30, 2013</b> <i>(in thousands)</i> | <b>Contractual<br/>payments for<br/>term<br/>licenses not recorded<br/>on the balance sheet (1)</b> | <b>Other contractual<br/>license payments not<br/>recorded on<br/>the<br/>balance<br/>sheet (2)</b> | <b>Total</b>      |
|---|---|---|-------------------|
| Remainder of 2013                                     | \$ 16,001   | \$ 4,927  | \$ 20,928         |
| 2014  | 62,844  | 17,514  | 80,358            |
| 2015  | 55,939  | 4,944   | 60,883            |
| 2016  | 45,154  | 3,128   | 48,282            |
| 2017 and thereafter                                   | 23,708  |   | 23,708            |
| <b>Total</b>  | <b>\$ 203,646</b>   | <b>\$ 30,513</b>  | <b>\$ 234,159</b> |

- (1) These amounts will be recognized as revenue in the future over the term of the agreement as payments become due or earlier if prepaid.
- (2) 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 used in investing activities**

During the first nine months of 2013, cash used in investing activities was primarily for purchases of marketable debt securities of \$56.6 million, partially offset by the proceeds received from the maturities of marketable debt securities of \$21.1 million.

During the first nine months of 2012, we invested \$21.9 million primarily in leasehold improvements, furniture and fixtures and equipment for the build-out of our U.S. and India offices.

**Cash used in financing activities**

Cash used in financing activities during the first nine months of 2013 and 2012 was primarily for repurchases of our common stock and dividend payments. Since 2004, our Board of Directors has approved annual stock repurchase programs that have authorized the repurchase in the aggregate of up to \$92.4 million of our common stock. Purchases under these programs have been made on the open market.

The following table is a summary of our repurchase activity under all of our repurchase programs during the first nine months of 2013 and 2012:

| <i>(Dollars in thousands)</i>               | <b>Nine Months Ended<br/>September 30,</b> |               |               |               |
|---|--|---------------|---------------|---------------|
|   |  | <b>2013</b>   |               | <b>2012</b>   |
|   | <b>Shares</b>                              | <b>Amount</b> | <b>Shares</b> | <b>Amount</b> |
| Prior year authorization as of January 1,   |  | \$ 14,793     |               | \$ 13,963     |
| Repurchases paid                            | 309,692                                    | (9,102)       | 125,891       | (3,861)       |
| Repurchases unsettled                       | 3,313                                      | (130)         | 1,692         | (48)          |
| Authorization remaining as of September 30, |  | \$ 5,561      |               | \$ 10,054     |

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

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During the first nine months of 2013 and 2012, option and RSU holders net settled stock options and vested RSUs representing the right to purchase a total of 529,000 shares and 424,000 shares, respectively, of which only 275,000 shares and 243,000 shares, respectively, were issued to the option and RSU holders and the balance of the shares were surrendered to us to pay for the exercise price and the applicable taxes. During the first nine months of 2013 and 2012, instead of receiving cash from the equity holders, we withheld shares with a value of \$4.1 million and \$3.6 million, respectively, for withholding taxes, and \$3.9 million and \$2.4 million, respectively, for the exercise price. The value of share repurchases and shares withheld for net settlement of our employee stock option exercises and vesting of RSUs offset the proceeds received under our various share-based compensation plans during the first nine months of 2013 and 2012.

**Dividends**

We declared a cash dividend of \$0.09 per share in the first nine months of 2013 and 2012. We paid cash dividends of \$2.3 million and \$3.4 million in the first nine months of 2013 and 2012, respectively. Our Board of Directors authorized the acceleration of the payment of the fourth quarter 2012 dividend to be paid in December 2012 rather than in January 2013. Therefore, there was no dividend payment in the first quarter of 2013. It is our current intention to pay a quarterly cash dividend of \$0.03 per share, however, the Board of Directors may terminate or modify this dividend program at any time without notice.

**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. We enter into foreign currency forward contracts to partially mitigate our exposure to the fluctuations in foreign exchange rates. See Note 3

Derivative Instruments in the notes to the accompanying unaudited condensed consolidated financial statements for further discussion.

There were no significant changes to our quantitative and qualitative disclosures about market risk during the first nine months of 2013. Please refer to Part II, Item 7A. Quantitative and Qualitative Disclosures about Market Risk included in our Annual Report on Form 10-K for the year ended December 31, 2012 for a more complete discussion of our market risk exposure.

**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 September 30, 2013. 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 September 30, 2013.

***(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 September 30, 2013 that have materially



affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**Table of Contents****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, 2012. 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. Except as described below, there have been no material changes during the first nine months of 2013 to the risk factors disclosed in our Annual Report on Form 10-K for the year ended December 31, 2012.

*The acquisition of other businesses and technologies may present new risks.* We have recently undertaken an acquisition and may continue to evaluate and consider other potential strategic transactions, including acquisitions of businesses, technologies, services, products and other assets in the future. These acquisitions, if undertaken, may involve significant new risks and uncertainties, including distraction of management attention away from our current business operations, insufficient new revenue to offset expenses, inadequate return on capital, integration challenges, new regulatory requirements, new third-party intellectual property infringement claims related to the acquired technology and/or services, and issues not discovered in our due diligence process. No assurance can be given that such acquisitions will be successful and will not adversely affect our profitability or operations.

**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 third quarter of 2013:

| Period               | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Share Repurchase Programs (1) | Approximate Dollar Value of Shares That May Yet Be Purchased Under Publicly Announced Share Repurchase Programs (in thousands) (1) |
|----------------------|----------------------------------|------------------------------|--|--|
| 7/1/2013 - 7/31/2013 | 24,446                           | \$ 33.84                     | 24,446   | \$ 6,762   |
| 8/1/2013 - 8/31/2013 | 24,714                           | 37.02                        | 24,714   | 5,847  |
| 9/1/2013 - 9/30/2013 | 7,469                            | 38.26                        | 7,469  | 5,561  |
| Total                | 56,629                           | \$ 35.81                     |  |  |

(1)

Since 2004, our Board of Directors has approved stock repurchase programs that have authorized the repurchase, in the aggregate, of up to \$92.4 million of our common stock. On December 18, 2012, we announced that our Board of Directors approved a \$6 million increase in the remaining funds available under the program expiring on December 31, 2012, and an extension of the expiration date to December 31, 2013. Under this program, the

Current Program, purchases may 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. We have 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 Current Program during closed trading window periods will be made pursuant to the 10b5-1 Plan.

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**Item 6. Exhibits**

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

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**SIGNATURE**

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: November 12, 2013

By:

/s/ RAFEAL E. BROWN

**Rafeal E. Brown**

**Chief Financial Officer, Chief Administration Officer and  
Senior**

**Vice President**

**(principal financial officer)**

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**PEGASYSTEMS INC.**

**Exhibit Index**

| <b>Exhibit<br/>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.   |
| 101                    | The following materials from Pegasystems Inc. s Quarterly Report on Form 10-Q for the quarter and nine months ended September 30, 2013 formatted in XBRL (Extensible Business Reporting Language): (i) the Unaudited Condensed Consolidated Balance Sheets, (ii) the Unaudited Condensed Consolidated Statements of Operations, (iii) the Unaudited Condensed Consolidated Statements of Comprehensive Income, (iv) the Unaudited Condensed Consolidated Statements of Cash Flows, and (v) the Notes to Unaudited Condensed Consolidated Financial Statements. |