

PEGASYSTEMS INC
Form 10-K
February 26, 2015
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

x **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT
of 1934**

For the fiscal year ended December 31, 2014

.. **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE
ACT of 1934**

Commission File No. 1-11859

PEGASYSTEMS INC.

(Exact name of Registrant as specified in its charter)

Massachusetts

(State or other jurisdiction of incorporation or organization)

(IRS Employer Identification No. 04-2787865)

One Rogers Street

Cambridge, MA

02142-1209

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(Address of principal executive offices)

(617) 374-9600

(zip code)

(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:

<u>Title of Each Class</u>	<u>Name of Each Exchange on Which Registered</u>
Common Stock, \$0.01 par value per share	NASDAQ Global Select Market

Securities registered pursuant to Section 12(g) of the Act:

None

Indicate by check mark if the Registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act of 1933. Yes No

Indicate by check mark if the Registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act. Yes No

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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. (Check one):

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company
(Do not check if a 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

The aggregate market value of the Registrant's common stock held by non-affiliates of the Registrant based on the closing price (as reported by NASDAQ) of such common stock on the last business day of the Registrant's most recently completed second fiscal quarter (June 30, 2014) was approximately \$747 million.

There were 76,342,028 shares of the Registrant's common stock, \$0.01 par value per share, outstanding on February 5, 2015.

DOCUMENTS INCORPORATED BY REFERENCE

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Portions of the Registrant's definitive proxy statement related to its 2015 annual meeting of stockholders to be filed subsequently are incorporated by reference into Part III of this report.

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PART I

Forward-looking statements

This Annual Report on Form 10-K contains or incorporates forward-looking statements within the meaning of section 27A of the Securities Act of 1933 and section 21E of the Securities Exchange Act of 1934. These forward-looking statements are based on current expectations, estimates, forecasts, and projections about the industry and markets in which we operate and management's beliefs and assumptions. 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, strategy, is intended to, project, guidance, or variations of such words and similar expressions are used to identify such forward-looking statements. These statements are not guarantees of future performance and involve certain risks, uncertainties, and assumptions that are difficult to predict. We have identified certain risk factors included in Item 1A of this Annual Report on Form 10-K that we believe could cause our actual results to differ materially from the forward-looking statements we make. We do not intend to update publicly any forward-looking statements, whether as a result of new information, future events, or otherwise.

ITEM 1. Business

Pegasystems Inc. was incorporated in Massachusetts in 1983. Our stock is traded on the NASDAQ Global Select Market under the symbol PEGA. Our Website address is www.pegacom. We are not including the information contained on our Website as part of, or incorporating it by reference into, this Annual Report on Form 10-K. Unless the context otherwise requires, references in this Annual Report on Form 10-K to the Company, Pega, we, us, or our refer to Pegasystems Inc. and its subsidiaries.

Our business: Applications Engineered for Evolution

We believe business success requires that organizations become digital, and that a new generation of strategic applications can accelerate how organizations become modern digital enterprises. We power the digital enterprise with strategic applications built on Pega 7, our unified on-Cloud and on-premises platform (Pega 7 or Pega 7 platform). Pega 7 is designed to allow business and information technology to collaborate by using a comprehensive set of visual models to build applications: process models, predictive analytics, user experience (UX) designs, decision logic, etc. This visual, model-based approach is designed to be faster in building, deploying, and evolving strategic applications than traditional programming, and to empower our clients to better engage their customers, simplify processes, and turn the power of change into a competitive advantage.

We develop, market, license, and support strategic software applications for marketing, sales and onboarding, customer service, and operations, in addition to licensing our Pega 7 platform for clients that wish to build and extend their own applications. Our software is designed to assist clients in building, deploying, and evolving strategic enterprise applications, creating an environment in which business and IT can collaborate to manage back-office operations, front office sales, marketing, and/or customer service needs.

Our applications and platform intersect with and encompass several traditional software markets, including: Customer Relationship Management (CRM), Business Process Management (BPM), Business Rules Management Systems (BRMS), Dynamic Case Management (DCM), Decision Management, including Predictive and Adaptive analytics, and the Vertical Specific Software (VSS) market of industry solutions and packaged applications.

We also provide consulting services and implementation support, training, and technical support services to help clients maximize the business value from our software. Our clients include Global 500 companies and government agencies that seek to manage complex enterprise systems and customer service issues more nimbly and cost-effectively. Our strategy is to sell a client a series of licenses, each focused on a specific purpose or area of operations. As we have found meaningful interest from smaller companies, we are expanding our sales force to extend coverage beyond our traditional Global 500 focus.

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Our partners

We maintain alliances with global systems integrators and technology consulting firms that provide consulting services to our clients. Strategic partnerships with technology consulting firms and systems integrators are important to our sales efforts because they influence buying decisions, help us to identify sales opportunities, and complement our software with their domain expertise and services capabilities. These partners may deliver strategic business planning, consulting, project management, and implementation services to our clients. Currently, our partners include well respected, major firms such as Accenture Ltd., Atos SE, Capgemini SA, Cognizant Technology Solutions Inc., Ernst & Young LLP, Infosys Technologies Limited, Mahindra Satyam, PricewaterhouseCoopers LLP, Tata Consultancy Services Limited, Virtusa Corporation, and Wipro Ltd.

Our products

Pega's applications streamline business operations, connect enterprises to their customers in real-time across channels, and adapt to meet changing requirements. Our applications can be deployed in the Cloud or on-premises, providing our clients with the flexibility to operate the software according to their own preferences.

Pega 7

Pega 7 is a unified platform that enables clients to build enterprise applications in a fraction of the time it would take using traditional programming technologies. Pega 7 is engineered to support complex global enterprises, allowing for application development and deployment on a patented layered architecture that supports reuse across lines of business, geographies, and customer segments. Our platform features a model-driven, visual code-free approach to application development that enables business and IT to collaborate, using a visual language that models the requirements and design of the application through readily understandable metaphors. This agile approach facilitates continuous improvement methodologies, such as Lean Six Sigma, to effectively manage individual projects or drive a complete enterprise transformation. All aspects of the application are captured in the model, including business strategy mapping, business processes, data models, case definitions, rules, decisions, reporting, interfaces, intelligent work management capabilities, business activity monitoring, and the UX across both web and mobile devices.

Once defined this way, the finished application and documentation are generated and immediately ready for use. Our approach bypasses the error-prone and time-consuming process of manually translating requirements into code. The software application is automatically created directly from the model, helping to close the costly gap between vision and execution. Changes to the code are made by changing the model, and application documentation is generated directly from the model as well. The Pega 7 platform is standards-based and can leverage a client's existing technology to create new business applications that cross technology silos and bridge front and back-office. Pega 7 was previously marketed as PegaRULES Process Commander and the Build for Change platform.

Strategic Applications

Pegasystems also offers purpose or industry-specific software applications built on the Pega 7 platform. These applications for Marketing, Sales and Onboarding, Customer Service and Support, and Operations provide a best-practice starting point as well as industry-specific business processes. As they are built on the Pega 7 foundation, these applications deliver flexibility beyond traditional commercial off the shelf products. We believe our applications allow our clients to offer differentiated service and value to their customers. Pega 7 enables organizations to quickly implement new processes, refine customer experiences, bring new offerings to market, and provide customized or specialized processing to help meet the needs of different customers, departments, geographies, or regulatory requirements.

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Pega Customer Relationship Management Applications

Pega's Customer Relationship Management Applications are designed to evolve to meet changing business needs. Our applications offer process-driven, customer-centric CRM software that maximizes the lifetime value of customers and helps reduce the costs of serving customers. We provide marketing, sales, and service applications to optimize sales processes and customer service interactions.

Pega Marketing helps enterprises manage customer relationships across inbound and outbound channels. It incorporates predictive and adaptive analytics and business rules in real time to evaluate the context of each customer interaction and dynamically recommends the most relevant action, offer, content, and channel.

Pega Customer Service provides a contact center desktop, case management for customer service, mobile field service, self-service, and industry specific processes and data models. It allows enterprises to deliver consistent interactions across channels, improves employee productivity, and allows organizations to adapt to changing business requirements.

Pega Sales Automation automates and manages the sales process from prospecting to product fulfillment. Our software allows enterprises to capture best practices and guides sales teams through the sales and customer onboarding processes.

Pega provides *Operations Applications* to support a variety of business needs including risk, fraud, and compliance management; exceptions and investigations; order fulfillment; claims processing; insurance underwriting; and product development.

These applications incorporate and leverage many common technical capabilities. Our case management and business process technology facilitates the fulfillment of customer requests, while our Next-Best-Action analytics predict and adapt to customer behavior to improve both business outcomes and the customer experience.

Decision management is incorporated into these applications to guide actions and optimize process outcomes based on business objectives. Capabilities for cross-sell/up-sell, retention, service recommendations, and collections that can be changed with model-driven tools help businesses deploy automated decision-making quickly. The predictive and adaptive analytics incorporated into these applications support the creation and refinement of decision models to improve outcomes.

Social listening, text analytics, and natural language processing capabilities are also available in our Pega Customer Relationship Management Applications. This allows our clients to collect social content in tweets, blogs, and posts on Facebook or in other social communities, and enrich it by detecting language, topic, taxonomy, and sentiment. Using this capability, our clients are able to monitor, triage, and respond to social content across multiple channels, and turn it into actionable social intelligence.

Our Pega Co-Browse collaboration technology enables contact center users to provide fast service by simultaneously co-browsing Web pages with their customers. The technology is designed to allow our clients to engage customers in real time, and can also be used to enable employees to collaborate on work across physical locations.

The Pega Mobile capabilities in our Pega 7 platform are designed to help clients efficiently build, manage, and deploy mobile applications as part of a unified Omni-channel experience. By using Pega Mobile, enterprises can deploy Pega applications as packaged, branded mobile applications and manage the complex elements of the mobile application lifecycle including security, integration, testing, and management of mobile applications and devices. Our mobile application development solutions help businesses to reduce the development time, deployment cost, and complexity associated with run-the-business mobile applications.

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Pega Cloud®

Pega Cloud® is Pegasystems offering that allows clients to create and deploy our software applications using an Internet-based infrastructure. This offering is designed to enable our clients to build, test, and deploy their applications in a secure Cloud environment, minimizing their infrastructure and hardware costs.

Our services and support

We offer services and support through our global customer success group, our global customer support group, and our PegaACADEMY training services group. We also utilize third party contractors to assist us in providing these services.

Global Customer Success

Our Global Customer Success group combines our sales and Pega consulting groups and provides guidance and implementation services to our clients and partners on how to best apply our technology and develop strong implementation expertise.

Global Customer Support

Our Global Customer Support group is responsible for technical support. Support services include problem tracking, prioritization and escalation procedures, periodic preventive maintenance, documentation updates, and new software releases.

PegaACADEMY Training Services

The success of our sales strategy for multiple follow-on sales to target clients depends on our ability to train a large number of partners and clients to implement our technology. We offer training for our staff, clients, and partners. Instructor-led training is offered at our regional training facilities in North America, the United Kingdom, India, Australia, and at third-party facilities in numerous other locations including client sites. Online training is an alternative way to learn our software quickly, easily, and cost effectively. We expect that the online training will help expand the number of trained experts at a faster pace. Our courses are designed to meet the specific requirements of process architects, system architects, and system administrators.

Our markets

Our target clients are primarily large, industry-leading organizations that require strategic applications to differentiate them in the markets they serve by increasing business agility, driving growth, improving productivity, attracting and retaining customers, and reducing risk. We deliver applications tailored to our clients specific industry needs as well as an application development platform for a multi-channel environment that can adapt to changing customer needs. We also enable enterprise transformation initiatives by providing an application development platform that digitizes end-to-end processes and allows for multi-channel customer interactions, all enhanced by Next-Best-Action analytics.

Our clients have typically been large companies in the financial services, healthcare, insurance, communications and media, public sector, manufacturing, and life sciences markets. We are expanding our client base to a broader range of companies in the Global 2000 within those markets as well as to additional industries.

Financial Services

Financial services organizations rely on software to market, onboard, cross-sell, retain, and service their customers as well as automate the operations that support these customer interactions. Our customer service and support, sales and new account onboarding, Know Your Customer (KYC), marketing, collections, and dispute management applications allow clients to be responsive to changing business requirements.

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Healthcare

Healthcare organizations seek software that integrates their front and back-offices and helps them deliver personalized care and customer service while reducing cost, automating processes, and increasing operational efficiency. Our applications allow healthcare clients to address sales, service, operations, financial, administrative, and coverage requirements of healthcare consumerism and reform.

Insurance

Insurance companies, whether competing globally or nationally for customers and channels, need software to automate the key activities of distribution management, quoting, underwriting, claims, and policy servicing. Insurers are also becoming increasingly sensitive to ways to improve customer service and the overall customer experience. Our applications for insurance carriers help increase business value by delivering customer-focused experiences and personalized interactions that help drive higher sales, lower expense ratios, and mitigate risk.

Communications and Media

Communications and media organizations need to address high levels of customer churn, growing pressure to increase revenue, and an ability to respond quickly to changing market conditions. Our applications enable organizations to reshape the way they market and sell to customers, streamline onboarding and fulfillment operations, and bring new services and products to market.

Public Sector

Government agencies need to modernize legacy systems and processes to meet the growing demands for improved constituent service, lower costs, and greater levels of transparency. Pega delivers advanced capabilities to streamline operations and optimize service delivery through an agile, multi-channel approach.

Manufacturing

Manufacturers worldwide are transforming their businesses to better engage customers and suppliers, as well as directly manage the performance of their products from the earliest designs throughout the product life-cycle. Our manufacturing applications address field service, reduce supplier risk, manage warranties, recalls, repairs, and returns as well as extend existing enterprise resource planning system capabilities.

Life Sciences

Life sciences organizations are looking for solutions to improve customer engagement as well as increase efficiencies and transparency across the product development lifecycle. Our customer engagement, clinical, and pharmacovigilance applications are designed to deliver customer engagement, safety and risk management, and regulatory transparency.

Other Industries

We offer software to a broad range of other types of companies and industries. For example, we sell our applications and platform to clients in transportation, retail, travel, energy, utilities, and other services.

Competition

We compete in the CRM (which includes marketing, sales, and customer service), BPM, Case Management, Decision Management, co-browsing, social engagement, and mobile application development platform software markets, as well as markets for the vertical applications we provide (e.g. KYC for Financial

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Services, Pharmacovigilance for Life Sciences). These markets are intensely competitive, rapidly changing, and highly fragmented, as current competitors expand their product offerings and new companies enter the market. Competitors vary in size and in the scope and breadth of the products and services they offer. We encounter competition from:

BPM vendors, including Service-Oriented Architecture (SOA) middleware vendors such as IBM, Oracle Corporation, Software AG, and Tibco Software Inc., and other BPM vendors such as Appian Corporation and the Cordys division of Open Text;

Case Management vendors such as the Documentum division of EMC Corporation, the FileNet division of IBM s Information Management Group, and the BPM/Case Management division of Open Text;

CRM application vendors such as Salesforce.com, the Siebel and RightNow divisions of Oracle, the Microsoft Dynamics CRM division of Microsoft, and IBM s Unica Marketing product;

Decision Management vendors including Business Rules Engine vendors such as the Operational Decision Management and SPSS divisions of IBM, and the Blaze division of FICO, and vendors of solutions that leverage predictive analytics in managing customer relationships including the Unica Division of IBM;

Companies that provide application specific software for the financial services, healthcare, insurance, and other specific markets such as Guidewire Software, Inc., the Detica NetReveal Division of BAE, SmartStream Technologies Ltd., SunGard, SAP, and the TriZetto division of Cognizant;

Mobile application development platform vendors, including IBM and SAP, as well as open source mobile technologies, including the jQuery Mobile platform from the jQuery Foundation;

Co-browsing software providers, including the Oracle s RightNow Cobrowse Cloud Service;

Social listening, text analytics, and natural language processing vendors, including Attensity, Visible Technologies, and Salesforce.com;

Professional service organizations that develop their own products or create custom software in conjunction with rendering consulting services; and

Clients current information technology departments, which may seek to modify their existing systems or develop their own proprietary systems.

We have been most successful competing for clients whose businesses are characterized by a high degree of change, complexity, or regulation. We believe that the principal competitive factors within our market include:

Product adaptability, scalability, functionality, and performance;

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Proven success in delivering cost-savings and efficiency improvements;

Proven success in enabling improved customer interactions;

Ease-of-use for developers, business units, and end-users;

Timely development and introduction of new products and product enhancements;

Establishment of a significant base of reference clients;

Ability to integrate with other products and technologies;

Customer service and support;

Product price;

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Vendor reputation; and

Relationships with systems integrators.

We believe we are competitively differentiated as our unified Pega 7 platform is designed to allow both client business and IT staff, using a single, intuitive user interface, to build enterprise applications in a fraction of the time it would take with the types of disjointed architectures and tools offered by our competitors. In addition, our applications, built on the Pega 7 platform, provide the same level of flexibility and ability to adapt to our clients' needs. We believe we compete favorably due to our expertise in our target industries and our long-standing client relationships. We believe we compete less favorably on the basis of some of these factors with respect to our larger competitors, many of which have greater sales, marketing, and financial resources, more extensive geographical presence, and greater name recognition than we do. In addition, we may be at a disadvantage with respect to our ability to provide expertise outside our target industries. See **Risk Factors** The market for our offerings is intensely and increasingly competitive, rapidly changing, and highly fragmented. in Item 1A of this Annual Report on Form 10-K.

Intellectual Property

We rely primarily on a combination of copyright, patent, trademark, and trade secrets laws, as well as confidentiality agreements to protect our proprietary rights. We have obtained patents relating to our system architecture and products in strategic global markets. We enter into confidentiality and license agreements with our employees, partners, clients, and other third parties and control access to and ownership of software, services, documentation, and other proprietary information as means to protect our proprietary rights.

Sales and marketing

We market our software and services primarily through a direct sales force. In addition, strategic partnerships with management consulting firms and major systems integrators are important to our sales efforts because they influence buying decisions, help us identify sales opportunities, and complement our software and services with their domain expertise and professional services capabilities. We also partner with technology providers and application developers.

To support our sales efforts, we conduct a broad range of marketing programs, including client and industry-targeted solution campaigns, trade shows, including our PegaWORLD user conference, solution seminars and Webinars, industry analyst and press relations, Web and digital marketing, community development, social media, and other direct and indirect marketing efforts. Our consulting staff, business partners, and other third parties also conduct joint and separate marketing campaigns that generate sales leads.

Sales by geography

Sales to clients based outside of the United States of America (U.S.) represented approximately 45% of our total revenue during each of the last three fiscal years. We have derived substantially all of our operating revenue from the sale and support of one group of similar products and services during each of the last three fiscal years. The majority of our long-lived assets were located within the U.S. at the end of each of the last three fiscal years. See Note 18, **Geographic Information and Major Clients**, included in the Notes to Consolidated Financial Statements included in Item 8 of this Annual Report on Form 10-K. See **Risk Factors** We face risks from operations and clients based outside of the U.S. in Item 1A of this Annual Report on Form 10-K.

Research and development

Our development organization is responsible for product architecture, core technology development, product testing, and quality assurance. Our product development priority is to continue expanding the capabilities of our technology. We intend to maintain and extend the support of our existing strategic applications, and we

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may choose to invest in additional strategic applications which incorporate the latest business innovations. We also intend to maintain and extend the support of popular hardware platforms, operating systems, databases, and connectivity options to facilitate easy and rapid deployment in diverse information technology infrastructures. Our goal with all of our products is to enhance product capabilities, ease of implementation, long-term flexibility, and the ability to provide improved client service.

During 2014, 2013, and 2012, research and development expenses were approximately \$108.6 million, \$79.7 million, and \$76.7 million, respectively. See Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations of this Annual Report on Form 10-K for further discussion. We expect that we will continue to commit significant resources to our product research and development in the future to maintain our leadership position.

Employees

As of January 31, 2015, we had 2,970 employees worldwide, of which 1,313 were based in North America, 617 were based in Europe, and 1,040 were based in Asia Pacific.

Backlog of license, maintenance, and services

As of December 31, 2014, we had software license, maintenance, Cloud, and services agreements with clients expected to result in approximately \$540.3 million of future revenue, of which we expect approximately \$315.3 million to be recognized in 2015. As of December 31, 2013, we had approximately \$505.9 million in backlog of client software license, maintenance, Cloud, and services agreements. Under some of these agreements, we must fulfill certain conditions prior to recognizing revenue, and there can be no assurance when, if ever, we will be able to satisfy all such conditions in each instance. Backlog may vary in any given period depending on the amount and timing of when arrangements are executed, as well as the mix between perpetual and term license arrangements. Business conditions could change and, therefore, backlog may not be a reliable indicator of future financial performance. See Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations of this Annual Report on Form 10-K for more detail regarding backlog.

Available Information

We make available our Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q and Current Reports on Form 8-K, and amendments to these reports, free of charge through our Website (www.pega.com/about-us/investors) as soon as reasonably practicable after we electronically file such material with, or furnish such material to, the Securities and Exchange Commission (SEC). The SEC maintains a Website that contains reports, proxy, and information statements and other information regarding issuers that file electronically with the SEC at www.sec.gov. We make available on our Website reports filed by our executive officers and Directors on Forms 3, 4, and 5 regarding their ownership of our securities. Our Code of Conduct, and any amendments to our Code of Conduct, is also available on our Website.

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ITEM 1A. RISK FACTORS

The following important factors could cause our actual business and financial results to differ materially from those contained in forward-looking statements made in this Annual Report on Form 10-K or elsewhere by management from time to time.

Factors relating to our financial results

The timing of our license revenue is difficult to predict accurately, which may cause our quarterly operating results to vary considerably. A change in the number or size of high value license arrangements, or a change in the mix between perpetual licenses, term licenses, and Pega Cloud® subscriptions can cause our revenues to fluctuate materially from quarter to quarter. In the event that our clients choose term licenses or Pega Cloud® subscriptions, we recognize the revenue over the license term or Pega Cloud subscription term, which may adversely affect our profitability in any period due to sales commissions being paid at the time of signing and the corresponding revenue being recognized over time. Other factors which may influence the predictability of our license revenue include: changes in customer budgets and decision making processes that could affect both the timing and size of transactions, the deferral of license revenue to future periods due to the timing of the execution of an agreement or our ability to deliver the products or services, changes in our business model, and/or our ability to execute on our marketing and sales strategies.

We budget for our selling and marketing, product development, and other expenses based on anticipated future revenue. If the timing or amount of revenue fails to meet our expectations in any given quarter, our financial performance is likely to be adversely affected because only small portions of expenses vary with revenue. As a result, period-to-period comparisons of our operating results are not necessarily meaningful and should not be relied upon to predict future performance. If our revenues and operating results do not meet the expectations of our investors or securities analysts or fall below guidance we may provide to the market, or due to other factors discussed elsewhere in this section, the price of our common stock may decline.

The number of our license arrangements has been increasing, and we may not be able to sustain this growth unless we and our partners can provide sufficient high quality consulting services, training, and maintenance resources to enable our clients to realize significant business value from our software. Our clients typically request consulting services and training to assist them in implementing our products. Our clients also purchase maintenance on our products in almost all cases. As a result, an increase in the number of license arrangements is likely to increase demand for consulting services, training, and maintenance relating to our products. Given that the number of our license arrangements has been increasing, we will need to provide our clients with more consulting services, training, and maintenance to enable our clients to realize significant business value from our software. We have been increasingly enabling our partners and clients through training to create an expanded universe of people that are skilled in the implementation of our products. However, if we and our partners are unable to provide sufficient high quality consulting services, training, or maintenance resources to our clients, our clients may not realize sufficient business value from our products to justify follow-on sales, which could impact our future financial performance. In addition, the growth required to meet the increased demand for our consulting services could strain our ability to deliver our services engagements at desired levels of profitability, thereby impacting our overall profitability and financial results.

We frequently enter into a series of licenses that are focused on a specific purpose or area of operations. If we are not successful in obtaining follow-on business from these clients, our financial performance could be adversely affected. We frequently enter into a series of licenses with our new clients that are focused on a specific purpose or area of operations. Once a client has realized the value of our software, we work with the client to identify opportunities for follow-on sales. However, we may not be successful in demonstrating this value to some clients, for reasons relating to the performance of our products, the quality of the services and support we provide for our products, or external reasons. Also, certain of our smaller clients may have limited additional sales opportunities available. For any of these clients, we may not obtain follow-on sales or the follow-on sales may be delayed, and our license revenue could be limited. This could lower the total value of all transactions and adversely affect our financial performance.

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Our consulting services revenue is dependent to a significant extent on closing new license transactions with clients. We derive a substantial portion of our consulting services revenue from implementation of new software licenses with our clients, both from implementations that are led by our consulting services staff and from implementations where we provide consulting to our partners and clients to support their implementations. Accordingly, it is imperative that we close more license transactions with our clients if we are to maintain or grow our consulting services revenue.

If we are unable to maintain vendor-specific objective evidence (VSOE) of fair value of our time and materials (T&M) consulting services arrangements, we may be required to delay the recognition of a portion of our revenue to future periods. We have established VSOE of fair value of our T&M consulting services in North America, Australia, and Europe, based on the price charged when these services are sold separately. The weakened economy and significant competition within our industry have created pricing pressure on consulting services provided by technology companies. If we elect to discount our T&M consulting services pricing or otherwise introduce variability in our T&M consulting services arrangements to attract or retain clients, this could lead to an insufficient number of consistently priced T&M consulting services arrangements for us to maintain VSOE. If we do not have VSOE of fair value of our T&M consulting services, we may be required to recognize all revenue for these consulting services arrangements, including any bundled license, maintenance, and other services revenue, ratably over the longer of the software maintenance period or the service period.

Our financial results may be adversely affected if we are required to change certain estimates, judgments, and/or positions relative to our income and other taxes. In the ordinary course of conducting our global business enterprise, we cannot be certain of the ultimate tax outcome related to many transactions and calculations. Some of these uncertainties arise as a consequence of positions we have taken regarding valuation of deferred tax assets, transfer pricing for transactions with our subsidiaries, and potential challenges to nexus and tax credit estimates. We estimate our exposure to unfavorable outcomes related to these uncertainties and estimate the probability of such outcomes. Future realization of our deferred tax assets ultimately depends on the existence of sufficient taxable income within the available carryback or carryforward periods. We record a valuation allowance to reduce our deferred tax assets to an amount we believe is more likely than not to be realized. If our taxable income is not consistent with our expectations or the timing of income is not within the applicable carryforward period, we may be required to establish a valuation allowance on all or a portion of these deferred tax assets. Changes in our valuation allowance impact income tax expense in the period of adjustment. Although we believe our estimates are reasonable, no assurance can be given that the final tax outcome of these matters or our current estimates regarding these matters will not be different from what is reflected in our historical income tax provisions, returns, and accruals. Such differences, or changes in estimates relating to potential differences, could have a material impact, unfavorable or favorable, on our income tax provisions, require us to change the recorded value of deferred tax assets, and adversely affect our financial results. We are also subject to non-income taxes such as payroll, sales, use, value-added, net worth, property and goods and services taxes in the U.S. and in various foreign jurisdictions. We are regularly under audit by tax authorities with respect to these non-income taxes and may have exposure to additional non-income tax liabilities which could have an adverse effect on our results of operations and financial condition.

If it became necessary to repatriate any of our foreign cash balances to the United States, we may be subject to increased income taxes, other restrictions, and limitations. As of December 31, 2014, approximately \$46.8 million of our cash and cash equivalents is held in our foreign subsidiaries. If we are unable to reinvest this cash outside of the U.S., we may have to repatriate some of our foreign cash to the U.S. which would increase our income tax liability. If it became 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 have not been 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 other factors.

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We are investing heavily in sales and marketing and support in anticipation of a continued increase in license arrangements, and we may experience decreased profitability or losses if we are unsuccessful in increasing the value of our license arrangements in the future to balance our growth in expenses. We have been increasing our investment in sales and marketing to meet increasing demand for our software by hiring additional sales and marketing personnel. We anticipate that we will need to provide our clients with more maintenance support as a result of this increase in demand, and also have been hiring additional personnel in this area. These investments have resulted in increased fixed costs that do not vary with the level of revenue. If the increased demand for our products does not continue, we could experience decreased profitability or losses as a result of these increased fixed costs.

Factors relating to our products and markets

We will need to acquire or develop new products, evolve existing ones, address any defects or errors, and adapt to technology change. Technical developments, client requirements, programming languages, and industry standards change frequently in our markets. As a result, success in current markets and new markets will depend upon our ability to enhance current products, address any product defects or errors, acquire or develop and introduce new products that meet client needs, keep pace with technology changes, respond to competitive products, and achieve market acceptance. Product development requires substantial investments for research, refinement, and testing. We may not have sufficient resources to make necessary product development investments. We may experience technical or other difficulties that will delay or prevent the successful development, introduction, or implementation of new or enhanced products. We may also experience technical or other difficulties in the integration of acquired technologies into our existing platform and applications. Inability to introduce or implement new or enhanced products in a timely manner could result in loss of market share if competitors are able to provide solutions to meet customer needs before we do, give rise to unanticipated expenses related to further development or modification of acquired technologies as a result of integration issues, and adversely affect future financial performance.

The market for our offerings is intensely and increasingly competitive, rapidly changing, and highly fragmented. We compete in the CRM, which includes marketing, sales, and customer service, BPM, Case Management, Decision Management, co-browsing, social engagement, and mobile application development platform software markets, as well as markets for the vertical applications we provide (e.g. KYC for Financial Services, Pharmacovigilance for Life Sciences). The markets for our software and related implementation, consulting, and training services are intensely competitive, rapidly changing, and highly fragmented. We currently encounter significant competition from internal information systems departments of potential or existing clients that develop custom software. We also compete with companies that target the BPM, Case Management, Decision Management, co-browsing, social engagement, and mobile application development platform markets as well as professional service organizations that develop custom software in conjunction with rendering consulting services. Competition for market share and pressure to reduce prices and make sales concessions are likely to increase. Many of our competitors, such as IBM, Oracle, and SAP, are large and have far greater resources and may be able to respond more quickly and efficiently to new or emerging technologies, programming languages, or standards or to changes in client requirements or preferences. Competitors may also be able to devote greater managerial and financial resources to develop, promote, and distribute products and to provide related consulting and training services. There can be no assurance that we will be able to compete successfully against current or future competitors or that the competitive pressures faced by us will not materially adversely affect our business, operating results, and financial condition.

The continued weakness in international economies may negatively impact our sales to, and the collection of receivables from, our financial services and, insurance clients and possibly our clients in other industries. Our sales to, and our collection of receivables from, our clients may be impacted by adverse changes in global economic conditions. In the past few years, the regions which we serve have experienced instability in financial markets, tightening credit, and weak overall economic conditions, which has impacted the financial services and insurance industries in particular. These trends could impact the ability and willingness of our

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financial services and insurance clients, and possibly our clients in other industries, to make investments in technology, which in turn may delay or reduce the number of purchases of our software and services. These factors could also impact the ability and willingness of these clients to pay their trade obligations and honor their contractual commitments under their noncancellable term licenses. These clients may also become subject to increasingly restrictive regulatory requirements, which could limit or delay their ability to proceed with new technology purchases and may result in longer sales cycles, increased price competition, and reductions in sales of our products and services. Our financial services and insurance clients as a group represent a significant amount of our revenues and receivables. Accordingly, their potential financial instability could negatively impact our business, operating results, and financial condition.

We have historically sold to the financial services, insurance, healthcare, and communications markets, and rapid changes or consolidation in these markets could affect the level of demand for our products. We have historically derived a significant portion of our revenue from clients in the financial services, insurance, healthcare, and communications markets, and sales to these markets are important for our future growth. Competitive pressures, industry consolidation, decreasing operating margins, regulatory changes, and privacy concerns affect the financial condition of our clients and their willingness to buy. In addition, clients' purchasing patterns in these industries for large technology projects are somewhat discretionary. The financial services and insurance markets are undergoing intense domestic and international consolidation and financial turmoil, and consolidation has been occurring in the healthcare and communications markets. Consolidation may interrupt normal buying behaviors and increase the volatility of our operating results. In recent years, several of our clients have been merged or consolidated, and we expect this to continue in the near future. Future mergers or consolidations may cause a decline in revenues and adversely affect our future financial performance. All of these factors affect the level of demand for our products from clients in these industries, and could adversely affect our business, operating results, and financial condition.

We rely on certain third-party relationships. We have a number of relationships with third parties that are significant to sales, marketing and support activities, and to product development efforts, including Cloud hosting facilities. We rely on software and hardware vendors, large system integrators, and technology consulting firms to provide marketing and sales opportunities for the direct sales force and to strengthen our products through the use of industry-standard tools and utilities. We also have relationships with third parties that distribute our products. There can be no assurance that these companies, most of which have significantly greater financial and marketing resources, will not develop or market products that compete with ours in the future or will not otherwise end or limit their relationships with us. Further, the use of third-party hosting facilities requires us to rely on data security as it is provided by such third parties, which despite our due diligence may be less than adequate.

We face risks from operations and clients based outside of the U.S. Sales to clients located outside of the U.S. represented approximately 45% of our total revenue in the last three fiscal years. We, in part through our wholly-owned subsidiaries, market products and render consulting and training services to clients based outside of the U.S. including clients based in Canada, Europe, the Middle East, Latin America, Asia, and Australia. We have established offices in North America, Europe (including Russia and Turkey), Asia (including India), and Australia. We believe that growth will necessitate expanded international operations, requiring a diversion of managerial attention and increased costs. We anticipate hiring additional personnel to accommodate international growth, and we may also enter into agreements with local distributors, representatives, or resellers. If we are unable to do one or more of these things in a timely manner, our growth, if any, in our foreign operations may be restricted, and our business, operating results, and financial condition could be materially and adversely affected.

In addition, we may not be able to maintain or increase international market demand for our products. Additional risks inherent in our international business activities generally include:

- laws and business practices favoring local competitors;
- compliance with multiple, conflicting and changing governmental laws and regulations, including employment, tax, privacy and data privacy and protection laws and regulations, increased tariffs and other trade barriers;

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the costs of localizing products for local markets, including translation into foreign languages and associated expenses;
longer payment cycles and credit and collectability risk on our foreign trade receivables;
difficulties in enforcing contractual and intellectual property rights;
heightened fraud and anti-bribery awareness risks;
treatment of revenue from international sources and changes to tax codes, including being subject to foreign tax laws, being liable for paying withholding income or other taxes in foreign jurisdictions, and other potentially adverse tax consequences (including restrictions on repatriating earnings and the threat of double taxation);
managing our international operations, including increased accounting and internal control expenses;
heightened risks of political and economic instability; and
foreign currency exchange rate fluctuations and controls.

There can be no assurance that one or more of these factors will not have a material adverse effect on our foreign operations, and, consequentially, our business, operating results, and financial condition.

We are exposed to fluctuations in currency exchange rates that could negatively impact our financial results and cash flows. Because a significant portion of our business is conducted outside the U.S., we face exposure to adverse movements in foreign currency exchange rates. These exposures may change over time as business practices evolve, and they could have a material adverse impact on our financial results and cash flows. Our international sales are usually denominated in foreign currencies. The operating expenses of our foreign operations are primarily denominated in foreign currencies, which partially offset our foreign currency exposure on our international sales. Our U.S. operating company invoices most of our foreign clients in their local currencies, so it holds cash and accounts receivable denominated in these foreign currencies, which are subject to foreign currency transaction gains or losses. We have historically entered into foreign currency forward contracts to manage our exposure to changes in foreign currency exchange rates affecting foreign currency denominated accounts receivable and cash held by our U.S. operating company. The use of these foreign currency forward contracts is intended to partially mitigate the exposure to the foreign currency transaction gains and losses. We are in the process of reassessing our hedging strategy and have not entered into any foreign currency forward contracts since February 2014. Although we may resume the use of foreign currency forward contracts in the future, amounts denominated in foreign currencies, particularly the British pound, Euro, Australian dollar, and Indian rupee relative to the U.S. dollar, may fluctuate in value and could adversely impact our financial results and cash flows.

Factors relating to our internal operations and potential liabilities

We depend on certain key personnel, and must be able to attract and retain qualified personnel in the future. The business is dependent on a number of key, highly skilled technical, managerial, consulting, sales, and marketing personnel, including our Chief Executive Officer who is also our founder and majority stockholder. The loss of key personnel could adversely affect financial performance. We do not have any significant key-man life insurance on any officers or employees and do not plan to obtain any. Our success will depend in large part on the ability to hire and retain qualified personnel, and rapidly replace and ramp up new management. The number of potential employees who have the extensive knowledge of computer hardware and operating systems needed to develop, sell, and maintain our products is limited, and competition for their services is intense, and there can be no assurance that we will be able to attract and retain such personnel. If we are unable to do so, our business, operating results, and financial condition could be materially adversely affected.

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We may not be able to achieve the key elements of our strategy and grow our business as anticipated. We currently intend to grow our business by pursuing strategic initiatives. Key elements of our strategy include utilizing our network of partner alliances to support our growth strategies and developing the talent and organizational structure capable of supporting our growth targets. We may not be able to achieve one or more of our key initiatives. Our success depends on our ability to appropriately manage our expenses as we grow our organization; successfully execute our marketing and sales strategies; successfully incorporate acquired technologies into our unified Pega 7 platform; and develop new products or product enhancements. If we are not able to execute on these actions, our business may not grow as we anticipated, and our operating results could be adversely affected.

We may experience significant errors or security flaws in our product and services, and could face privacy, product liability, and/or warranty claims as a result. Despite quality testing prior to their release, software products frequently contain errors or security flaws, especially when first introduced or when new versions are released. Errors in our software products could affect the ability of our products to work with other hardware or software products, or could delay the development or release of new products or new versions of products. Additionally, the detection and correction of any security flaws can be time consuming and costly. Errors or security flaws in our software could result in the inadvertent disclosure of confidential information or personal data relating to our clients, employees, or third parties. Software product errors and security flaws in our products or services could expose us to privacy, product liability, and/or warranty claims as well as harm our reputation, which could impact our future sales of products and services. Typically, we enter into license agreements that contain provisions intended to limit the nature and extent of our risk of product liability and warranty claims. There is a risk that a court might interpret these terms in a limited way or could hold part or all of these terms to be unenforceable. Also, there is a risk that these contract terms might not bind a party other than the direct client. Furthermore, some of our licenses with our clients are governed by non-U.S. law, and there is a risk that foreign law might give us less or different protection. Although we have not experienced any material product liability claims to date, a product liability suit or action claiming a breach of warranty, whether or not meritorious, could result in substantial costs and a diversion of management's attention and our resources.

We face risks related to intellectual property claims or appropriation of our intellectual property rights. We rely primarily on a combination of copyright, trademark, and trade secrets laws, as well as confidentiality agreements to protect our proprietary rights. We have obtained patents in strategically important global markets relating to the architecture of our systems. We cannot assure that such patents will not be invalidated or circumvented or that rights granted thereunder or the claims contained therein will provide us with competitive advantages. Moreover, despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy aspects of our products or to obtain the use of information that we regard as proprietary. In addition, the laws of some foreign countries do not protect our proprietary rights to as great an extent as do the laws of the U.S. There can be no assurance that our means of protecting our proprietary rights will be adequate or that our competitors will not independently develop similar technology.

There can be no assurance that third parties, including clients, will not claim infringement by us with respect to current or future products. Although we attempt to limit the amount and type of our contractual liability for infringement of the proprietary rights of third parties, and also assert ownership of work product and intellectual property rights as appropriate, there are often exceptions, and we cannot be assured that limitations will be applicable and enforceable in all cases. Even if limitations are found to be applicable and enforceable, our liability to our clients for these types of claims could be material in amount given the size of certain of our transactions. We expect that software product developers will increasingly be subject to infringement claims as the number of products and competitors in our industry segment grows and the functionality of products in different industry segments overlaps. Any such claims, with or without merit, could be time-consuming, result in costly litigation, cause product shipment and delivery delays, or require us to enter into royalty or licensing agreements. Such royalty or licensing agreements, if required, may not be available on terms acceptable to us or at all, which could have a material adverse effect upon our business, operating results, and financial condition.

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We are subject to increasingly complex and burdensome U.S. and foreign laws and regulations, and any failure to comply with these laws and regulations could subject us to, among other things, penalties and legal expenses that could harm our reputation or have a material adverse effect on our business, financial condition and results of operations. We are subject to extensive federal, state and foreign laws and regulations including but not limited to the U.S. Foreign Corrupt Practices Act, the U.K. Bribery Act, data privacy, protection and security laws, and similar laws and regulations. The Foreign Corrupt Practices Act, the U.K. Bribery Act and similar foreign anti-bribery laws generally prohibit companies and their intermediaries from making improper payments for the purpose of obtaining or retaining business. Similar laws and regulations exist in many other countries throughout the world in which we do or intend to do business. Data privacy laws and regulations in Europe, Australia, Latin America and elsewhere are undergoing rapid transformation towards increased restrictions. We have developed and implemented a compliance program based on what we believe are current best practices, including the background checking of our major vendor and distribution partners and the creation of a data privacy center of excellence, but we cannot guarantee that we, our employees, our consultants or our contractors are or will be in compliance with all federal, state and foreign regulations, particularly as we expand our operations outside of the U.S. If we or our representatives fail to comply with any of these laws or regulations, a range of fines, penalties and/or other sanctions could be imposed on us, which could have a material adverse effect on our business, financial condition and results of operations. Even if we are not determined to have violated these laws, government investigations into these issues typically require the expenditure of significant resources and generate negative publicity, which could also have an adverse effect on our business, financial condition and results of operations. In addition, regulation of data privacy, protection, and security laws is increasing worldwide, including various restrictions on cross-border access or transfer of data including personal data of our employees, clients and customers of our clients. Compliance with such regulations may increase our costs and there is a risk of enforcement of such laws resulting in damage to our brand as well as financial penalties, which could be significant.

Security of our systems and of global customer data is a growing challenge on many fronts. Security breaches may expose us to significant legal and financial liabilities. Our security measures, and those of our clients, may be breached as a result of third-party action, or that of employees, consultants, or others, including intentional misconduct by computer hackers, system error, human error, technical flaws in our products, or otherwise. Because the techniques used to obtain unauthorized access or to sabotage systems change frequently and generally are not recognized until launched against a target, we may be unable to anticipate these techniques or to implement adequate preventative measures. While we have invested in the protection of our data and systems, and our clients' data, to reduce these risks, there can be no assurance that our efforts will prevent breaches. Security breaches could expose us and our clients to a risk of loss or misuse of this information. Any security breach could result in a loss of confidence in the security of our service, damage our reputation, disrupt our business, lead to legal liability, and negatively impact our future sales. We carry data breach insurance coverage to potentially mitigate the financial impact of such potential legal liability, though this m