

PEGASYSTEMS INC
Form 10-Q
October 27, 2015
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

**Quarterly Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the quarterly period ended September 30, 2015**

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 (State or other jurisdiction of | 04-2787865 (IRS Employer |
| incorporation or organization) | Identification No.) |
| One Rogers Street Cambridge, MA (Address of principal executive offices) | 02142-1209 (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 <input checked="" type="checkbox"/> | Accelerated filer <input type="checkbox"/> |
| Non-accelerated filer <input type="checkbox"/> (Do not check if smaller reporting company) | Smaller reporting company <input type="checkbox"/> |

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 76,421,098 shares of the Registrant's common stock, \$.01 par value per share, outstanding on October 16, 2015.

Table of Contents

PEGASYSTEMS INC.

Index to Form 10-Q

| | Page |
|---|-------------|
| <u>Part I Financial Information</u> | |
| Item 1. <u>Financial Statements (Unaudited):</u> | |
| <u>Condensed Consolidated Balance Sheets as of September 30, 2015 and December 31, 2014</u> | 3 |
| <u>Condensed Consolidated Statements of Operations for the three and nine months ended September 30, 2015 and 2014</u> | 4 |
| <u>Condensed Consolidated Statements of Comprehensive Income (Loss) for the three and nine months ended September 30, 2015 and 2014</u> | 5 |
| <u>Condensed Consolidated Statements of Cash Flows for the nine months ended September 30, 2015 and 2014</u> | 6 |
| <u>Notes to Condensed Consolidated Financial Statements</u> | 7 |
| Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 16 |
| Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u> | 25 |
| Item 4. <u>Controls and Procedures</u> | 26 |
| <u>Part II Other Information</u> | |
| Item 1A. <u>Risk Factors</u> | 26 |
| Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u> | 26 |
| Item 6. <u>Exhibits</u> | 27 |
| <u>SIGNATURE</u> | 28 |

Table of Contents

PEGASYSTEMS INC.

UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands)

| | As of September 30, 2015 | As of December 31, 2014 |
|--|--------------------------------|-------------------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 97,278 | \$ 114,585 |
| Marketable securities | 126,738 | 96,631 |
| Total cash, cash equivalents, and marketable securities | 224,016 | 211,216 |
| Trade accounts receivable, net of allowance of \$2,100 and \$1,540 | 129,252 | 154,844 |
| Deferred income taxes | 12,903 | 12,974 |
| Income taxes receivable | 14,688 | 4,502 |
| Other current assets | 12,310 | 9,544 |
| Total current assets | 393,169 | 393,080 |
| Property and equipment, net | 31,830 | 30,156 |
| Long-term deferred income taxes | 71,998 | 69,258 |
| Long-term other assets | 3,715 | 2,783 |
| Intangible assets, net | 36,412 | 45,664 |
| Goodwill | 46,816 | 46,860 |
| Total assets | \$ 583,940 | \$ 587,801 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Accounts payable | \$ 7,617 | \$ 4,752 |
| Accrued expenses | 39,049 | 42,958 |
| Accrued compensation and related expenses | 43,386 | 47,250 |
| Deferred revenue | 134,075 | 134,672 |
| Total current liabilities | 224,127 | 229,632 |
| Income taxes payable | 24,562 | 24,896 |

Edgar Filing: PEGASYSTEMS INC - Form 10-Q

| | | |
|---|-------------------|-------------------|
| Long-term deferred revenue | 13,857 | 20,859 |
| Other long-term liabilities | 16,348 | 17,709 |
| Total liabilities | 278,894 | 293,096 |
| Stockholders' equity: | | |
| Preferred stock, 1,000 shares authorized; no shares issued and outstanding | | |
| Common stock, 200,000 shares authorized; 76,465 shares and 76,357 shares issued and outstanding | 765 | 764 |
| Additional paid-in capital | 145,466 | 141,495 |
| Retained earnings | 161,522 | 153,058 |
| Accumulated other comprehensive loss | (2,707) | (612) |
| Total stockholders' equity | 305,046 | 294,705 |
| Total liabilities and stockholders' equity | \$ 583,940 | \$ 587,801 |

See notes to unaudited condensed consolidated financial statements.

Table of Contents

PEGASYSTEMS INC.

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share amounts)

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|-----------------------------------|-------------------------------------|----------------|------------------------------------|----------------|
| | 2015 | 2014 | 2015 | 2014 |
| Revenue: | | | | |
| Software license | \$ 58,948 | \$ 48,292 | \$ 180,420 | \$ 154,918 |
| Maintenance | 52,285 | 47,281 | 150,366 | 137,555 |
| Services | 51,170 | 42,058 | 147,554 | 128,607 |
| Total revenue | 162,403 | 137,631 | 478,340 | 421,080 |
| Cost of revenue: | | | | |
| Software license | 1,000 | 1,076 | 3,106 | 3,832 |
| Maintenance | 5,644 | 5,385 | 16,300 | 15,093 |
| Services | 48,797 | 39,921 | 140,875 | 120,061 |
| Total cost of revenue | 55,441 | 46,382 | 160,281 | 138,986 |
| Gross profit | 106,962 | 91,249 | 318,059 | 282,094 |
| Operating expenses: | | | | |
| Selling and marketing | 53,640 | 48,623 | 169,764 | 150,772 |
| Research and development | 33,032 | 28,558 | 94,248 | 80,490 |
| General and administrative | 9,579 | 8,825 | 26,138 | 28,377 |
| Acquisition-related | | 54 | 39 | 417 |
| Restructuring | | 192 | | 192 |
| Total operating expenses | 96,251 | 86,252 | 290,189 | 260,248 |
| Income from operations | 10,711 | 4,997 | 27,870 | 21,846 |
| Foreign currency transaction loss | (412) | (2,845) | (4,342) | (2,527) |
| Interest income, net | 278 | 181 | 807 | 468 |
| Other (expense) income, net | (331) | 19 | (328) | (507) |

Edgar Filing: PEGASYSTEMS INC - Form 10-Q

| | | | | |
|---|----------|----------|-----------|-----------|
| Income before provision for income taxes | 10,246 | 2,352 | 24,007 | 19,280 |
| Provision for income taxes | 3,921 | 470 | 8,643 | 6,129 |
| Net income | \$ 6,325 | \$ 1,882 | \$ 15,364 | \$ 13,151 |
| Earnings per share: | | | | |
| Basic | \$ 0.08 | \$ 0.02 | \$ 0.20 | \$ 0.17 |
| Diluted | \$ 0.08 | \$ 0.02 | \$ 0.19 | \$ 0.17 |
| Weighted-average number of common shares outstanding: | | | | |
| Basic | 76,534 | 76,351 | 76,521 | 76,312 |
| Diluted | 79,174 | 78,653 | 78,906 | 78,531 |
| Cash dividends declared per share | \$ 0.03 | \$ 0.03 | \$ 0.09 | \$ 0.075 |

See notes to unaudited condensed consolidated financial statements.

Table of Contents**PEGASYSTEMS INC.****UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)****(in thousands)**

| | Three Months Ended | | Nine Months Ended | |
|--|---------------------------|-------------|--------------------------|-------------|
| | September 30, | | September 30, | |
| | 2015 | 2014 | 2015 | 2014 |
| Net income | \$ 6,325 | \$ 1,882 | \$ 15,364 | \$ 13,151 |
| Other comprehensive loss, net: | | | | |
| Unrealized gain (loss) on securities, net of tax | 162 | (90) | 167 | (62) |
| Foreign currency translation adjustments | (928) | (3,046) | (2,262) | (1,770) |
| Total other comprehensive loss, net | (766) | (3,136) | (2,095) | (1,832) |
| Comprehensive income (loss) | \$ 5,559 | \$ (1,254) | \$ 13,269 | \$ 11,319 |

See notes to unaudited condensed consolidated financial statements.

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

| | Nine Months Ended September 30, | |
|--|--|-------------|
| | 2015 | 2014 |
| Operating activities: | | |
| Net income | \$ 15,364 | \$ 13,151 |
| Adjustments to reconcile net income to cash provided by operating activities: | | |
| Excess tax benefits from exercise or vesting of equity awards | (4,661) | (3,754) |
| Deferred income taxes | (2,889) | (1,845) |
| Depreciation and amortization | 17,570 | 17,167 |
| Stock-based compensation expense | 23,005 | 13,721 |
| Foreign currency transaction loss | 4,342 | 2,527 |
| Other non-cash items | 1,129 | 939 |
| Change in operating assets and liabilities: | | |
| Trade accounts receivable | 21,969 | 59,049 |
| Income taxes receivable and other current assets | (8,670) | (3,839) |
| Accounts payable and accrued expenses | (4,108) | (1,448) |
| Deferred revenue | (6,925) | 4,287 |
| Other long-term assets and liabilities | (1,198) | (1,688) |
| Cash provided by operating activities | 54,928 | 98,267 |
| Investing activities: | | |
| Purchases of marketable securities | (66,946) | (36,232) |
| Proceeds from maturities and called marketable securities | 33,916 | 22,156 |
| Sale of marketable securities | 1,915 | |
| Payments for acquisitions | (1,671) | (2,600) |
| Investment in property and equipment | (9,950) | (5,809) |
| Cash used in investing activities | (42,736) | (22,485) |
| Financing activities: | | |

Edgar Filing: PEGASYSTEMS INC - Form 10-Q

| | | |
|---|-----------|------------|
| Issuance of common stock for share-based compensation plans | 722 | 629 |
| Excess tax benefits from exercise or vesting of equity awards | 4,661 | 3,754 |
| Dividend payments to shareholders | (6,896) | (4,581) |
| Common stock repurchases for tax withholdings for net settlement of equity awards | (7,149) | (4,939) |
| Common stock repurchases under share repurchase programs | (17,000) | (12,266) |
| Cash used in financing activities | (25,662) | (17,403) |
| Effect of exchange rates on cash and cash equivalents | (3,837) | (2,065) |
| Net (decrease) increase in cash and cash equivalents | (17,307) | 56,314 |
| Cash and cash equivalents, beginning of period | 114,585 | 80,231 |
| Cash and cash equivalents, end of period | \$ 97,278 | \$ 136,545 |

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, 2014.

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 2015.

2. NEW ACCOUNTING PRONOUNCEMENTS

Revenue from Contracts with Customers: In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2014-09, Revenue from Contracts with Customers (Topic 606). This ASU amends the guidance for revenue recognition to replace numerous, industry-specific requirements, and converges areas under this topic with those of the International Financial Reporting Standards. This ASU implements a five-step process for customer contract revenue recognition that focuses on transfer of control, as opposed to transfer of risk and rewards. This ASU also requires enhanced disclosures regarding the nature, amount, timing, and uncertainty of revenues and cash flows from contracts with customers. This ASU originally had an effective date for the Company of January 1, 2017. In August 2015, the FASB issued ASU No. 2015-14, Revenue from Contracts with Customers (Topic 606) Deferral of the Effective Date, which defers the effective date by one year while providing the option to adopt the standard on the original effective date. The new effective date for the Company will be January 1, 2018. Management is currently assessing the impact the adoption of this ASU will have on the Company's consolidated financial statements.

Table of Contents**3. MARKETABLE SECURITIES**

| (in thousands) | September 30, 2015 | | | |
|-------------------------|--------------------|------------------|-------------------|------------|
| | Amortized Cost | Unrealized Gains | Unrealized Losses | Fair Value |
| Municipal bonds | \$ 52,207 | \$ 110 | \$ | \$ 52,317 |
| Corporate bonds | 71,530 | 25 | (31) | 71,524 |
| Certificates of deposit | 2,894 | 3 | | 2,897 |
| | \$ 126,631 | \$ 138 | \$ (31) | \$ 126,738 |

| (in thousands) | December 31, 2014 | | | |
|-------------------------|-------------------|------------------|-------------------|------------|
| | Amortized Cost | Unrealized Gains | Unrealized Losses | Fair Value |
| Municipal bonds | \$ 27,820 | \$ 52 | \$ (17) | \$ 27,855 |
| Corporate bonds | 65,487 | 5 | (144) | 65,348 |
| Certificates of deposit | 3,428 | 2 | (2) | 3,428 |
| | \$ 96,735 | \$ 59 | \$ (163) | \$ 96,631 |

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 loss, net of related income taxes.

As of September 30, 2015, remaining maturities of marketable debt securities ranged from October 2015 to September 2018, with a weighted-average remaining maturity of approximately 16 months.

4. DERIVATIVE INSTRUMENTS

The Company has historically used foreign currency forward contracts (forward contracts) to manage its exposure to changes in foreign currency exchange rates associated with its foreign currency denominated cash, accounts receivable, and intercompany receivables and payables held by its U.S. operating company.

Effective on April 1, 2015, the Company restructured its operations with its clients based outside the Americas. These clients began transacting with Pegasystems Limited, a United Kingdom (U.K.) subsidiary of Pegasystems Inc., which has the British pound as its functional currency. This reorganization resulted in increased cash, accounts receivable, and intercompany receivables and payables held by Pegasystems Limited in currencies other than the British pound. As a result, the Company's exposure to foreign currency exchange rate fluctuations in the U.S. dollar, the Euro, and the Australian dollar relative to the British pound increased, while its exposure to foreign currency exchange rate fluctuations in the British pound, the Euro, and the Australian dollar relative to the U.S. dollar decreased.

In July 2015, as a result of this operational reorganization, the Company implemented its revised hedging program under which it fully or partially hedges its non-functional currency exposures for Pegasystems Inc. and Pegasystems Limited, utilizing forward contracts with terms not greater than six months.

The forward contracts are not designated as hedging instruments. As a result, the Company records the fair value of these contracts at the end of each reporting period in its consolidated balance sheets as other current assets for unrealized gains and accrued expenses for unrealized losses, with any fluctuations in the value of these contracts recognized in other (expense) income, net, in its consolidated statements of operations. The cash flows related to these forward contracts are classified as operating activities in the Company's consolidated statements of cash flows.

As of September 30, 2015, the total notional amount of the Company's outstanding forward contracts was \$55.7 million. The Company did not have any outstanding forward contracts as of December 31, 2014.

Table of Contents

The fair value of the Company's outstanding forward contracts as of September 30, 2015 was as follows:

| (in thousands) | Asset Derivatives | | Liability Derivatives | |
|------------------------------------|------------------------|------------|------------------------|------------|
| | Balance Sheet Location | Fair Value | Balance Sheet Location | Fair Value |
| Foreign currency forward contracts | Other current assets | \$ 140 | Accrued expenses | \$ 1,035 |

The Company entered into forward contracts with notional values as follows:

| Currency (in thousands) | Notional Amount | | | |
|-------------------------|-------------------------------------|------|------------------------------------|------------|
| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
| | 2015 | 2014 | 2015 | 2014 |
| Euro | 33,309 | | 33,309 | 21,900 |
| British pound | £ 10,300 | £ | £ 10,300 | £ 26,500 |
| Australian dollar | A\$ 27,000 | A\$ | A\$ 27,000 | A\$ 12,900 |
| Indian rupee | Rs 300,000 | Rs | Rs 300,000 | Rs 204,000 |
| United States dollar | \$ 45,500 | \$ | \$ 45,500 | \$ |

| (in thousands) | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|-------------------------------------|------------|------------------------------------|------------|
| | 2015 | 2014 | 2015 | 2014 |
| Loss from the change in the fair value of forward contracts included in other (expense) income, net | \$ (319) | \$ | \$ (319) | \$ (532) |
| Foreign currency transaction losses from the remeasurement of foreign currency assets and liabilities | \$ (412) | \$ (2,845) | \$ (4,342) | \$ (2,527) |

5. FAIR VALUE MEASUREMENTS

Assets and Liabilities Measured at Fair Value on a Recurring Basis

The Company records its marketable securities and forward contracts 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 inputs that are observable either directly or indirectly; and (Level 3) significant unobservable inputs

on which there is little or no market data, which require 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.

The Company's money market funds are classified within Level 1 of the fair value hierarchy. The Company's investments classified within Level 2 of the fair value hierarchy are valued based on a market approach using quoted prices, when available, or matrix pricing compiled by third party pricing vendors, using observable market inputs such as interest rates, yield curves, and credit risk. The Company's foreign currency forward contracts which are all classified within Level 2 of the fair value hierarchy are valued based on the notional amounts and rates under the contracts and observable market inputs such as currency exchange rates and credit risk. If applicable, the Company will recognize transfers into and out of levels within the fair value hierarchy at the end of the reporting period in which the actual event or change in circumstance occurs. There were no significant transfers between Level 1 and Level 2 during the three and nine months ended September 30, 2015.

Table of Contents

The Company's assets and liabilities measured at fair value on a recurring basis consisted of the following:

| (in thousands) | Fair Value Measurements at Reporting Date Using | | |
|------------------------------------|---|-----------|-------------------|
| | September 30, 2015 | Level 1 | Level 2 |
| Fair Value Assets: | | | |
| Money market funds | \$ 479 | \$ 479 | \$ |
| Marketable securities: | | | |
| Municipal bonds | \$ 52,317 | \$ | \$ 52,317 |
| Corporate bonds | 71,524 | | 71,524 |
| Certificates of deposit | 2,897 | | 2,897 |
| Total marketable securities | \$ 126,738 | \$ | \$ 126,738 |
| Foreign currency forward contracts | \$ 140 | \$ | \$ 140 |
| | \$ 127,357 | \$ 479 | \$ 126,878 |
| Fair Value Liabilities: | | | |
| Foreign currency forward contracts | \$ 1,035 | \$ | \$ 1,035 |

| (in thousands) | Fair Value Measurements at Reporting Date Using | | |
|------------------------------------|---|-----------|------------------|
| | December 31, 2014 | Level 1 | Level 2 |
| Fair Value Assets: | | | |
| Money market funds | \$ 2,295 | \$ 2,295 | \$ |
| Marketable securities: | | | |
| Municipal bonds | \$ 27,855 | \$ | \$ 27,855 |
| Corporate bonds | 65,348 | | 65,348 |
| Certificates of deposit | 3,428 | | 3,428 |
| Total marketable securities | \$ 96,631 | \$ | \$ 96,631 |
| | \$ 98,926 | \$ 2,295 | \$ 96,631 |

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 nine months of 2015 and 2014, the Company did not recognize any impairments on its assets measured at fair value on a nonrecurring basis.

Table of Contents**6. TRADE ACCOUNTS RECEIVABLE, NET OF ALLOWANCE**

| (in thousands) | September 30, December 31, | |
|------------------------------------|----------------------------|-------------------|
| | 2015 | 2014 |
| Trade accounts receivable | \$ 113,207 | \$ 128,757 |
| Unbilled trade accounts receivable | 18,145 | 27,627 |
| Total accounts receivable | 131,352 | 156,384 |
| Allowance for sales credit memos | (2,100) | (1,540) |
| | \$ 129,252 | \$ 154,844 |

Unbilled trade accounts receivable primarily relate to services revenue earned under time and materials arrangements and to maintenance and license arrangements that have commenced or been delivered but have not been invoiced.

7. GOODWILL AND OTHER INTANGIBLE ASSETS

Changes in the carrying amount of goodwill:

| (in thousands) | 2015 |
|------------------------------------|------------------|
| Balance as of January 1, | \$ 46,860 |
| Translation adjustments | (44) |
| Balance as of September 30, | \$ 46,816 |

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

| (in thousands) | Range of Useful Lives | Cost | Accumulated Amortization | Net Book Value |
|---------------------------------|-----------------------|-----------|--------------------------|----------------|
| As of September 30, 2015 | | | | |
| Customer related intangibles | 4-9 years | \$ 49,567 | \$ (28,933) | \$ 20,634 |
| Technology | 3-9 years | 48,342 | (32,931) | 15,411 |
| Other intangibles | 3 years | 5,361 | (4,994) | 367 |

| | | | | | | |
|-------|----|---------|----|----------|----|--------|
| Total | \$ | 103,270 | \$ | (66,858) | \$ | 36,412 |
|-------|----|---------|----|----------|----|--------|

| (in thousands) | Range of Useful Lives | Cost | Accumulated Amortization | Net Book Value |
|--------------------------------|-----------------------|------------|--------------------------|----------------|
| As of December 31, 2014 | | | | |
| Customer related intangibles | 4-9 years | \$ 49,590 | \$ (24,338) | \$ 25,252 |
| Technology | 3-9 years | 48,342 | (28,890) | 19,452 |
| Other intangibles | 1-3 years | 5,361 | (4,401) | 960 |
| Total | | \$ 103,293 | \$ (57,629) | \$ 45,664 |

Amortization of intangibles was reflected in the Company's unaudited condensed consolidated statements of operations as follows:

| (in thousands) | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|----------------------------|----------------------------------|----------|---------------------------------|-----------|
| | 2015 | 2014 | 2015 | 2014 |
| Cost of revenue | \$ 1,351 | \$ 1,382 | \$ 4,041 | \$ 4,666 |
| Selling and marketing | 1,537 | 1,501 | 4,602 | 4,496 |
| General and administrative | 91 | 574 | 593 | 1,475 |
| Total amortization expense | \$ 2,979 | \$ 3,457 | \$ 9,236 | \$ 10,637 |

Table of Contents

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

| (in thousands) as of September 30, 2015 | Future estimated amortization expense |
|--|--|
| Remainder of 2015 | \$ 2,972 |
| 2016 | 11,520 |
| 2017 | 9,822 |
| 2018 | 8,822 |
| 2019 and thereafter | 3,276 |
| | \$ 36,412 |

8. ACCRUED EXPENSES

| (in thousands) | September 30, 2015 | December 31, 2014 |
|---|-------------------------------|------------------------------|
| Partner commissions | \$ 3,421 | \$ 2,441 |
| Other taxes | 9,744 | 10,970 |
| Employee reimbursable expenses | 2,544 | 1,474 |
| Dividends payable | 2,298 | 2,294 |
| Professional services contractor fees | 5,100 | 2,297 |
| Self-insurance health and dental claims | 2,471 | 2,115 |
| Professional fees | 1,936 | 2,444 |
| Short-term deferred rent | 1,581 | 1,446 |
| Income taxes payable | 1,175 | 8,966 |
| Acquisition-related expenses and merger consideration | 1,085 | 2,702 |
| Restructuring | 397 | 461 |
| Marketing and sales program expenses | 1,698 | 1,914 |
| Purchased securities settled after period end | 331 | |
| Cloud hosting expenses | 771 | 516 |
| Foreign currency forward contracts | 1,035 | |
| Leasehold improvements in process | 681 | |
| Other | 2,781 | 2,918 |

\$ 39,049 \$ 42,958

Table of Contents**9. DEFERRED REVENUE**

| (in thousands) | September 30, December 31, | |
|----------------------------|----------------------------|------------|
| | 2015 | 2014 |
| Software license | \$ 33,495 | \$ 38,961 |
| Maintenance | 80,830 | 83,467 |
| Cloud | 8,151 | 4,209 |
| Services and other | 11,599 | 8,035 |
| Current deferred revenue | 134,075 | 134,672 |
| Software license | 13,724 | 19,878 |
| Maintenance and services | 133 | 981 |
| Long-term deferred revenue | 13,857 | 20,859 |
| | \$ 147,932 | \$ 155,531 |

10. STOCK-BASED COMPENSATION

Stock-based compensation expense was reflected in the Company's unaudited condensed consolidated statements of operations as follows:

| (in thousands) | Three Months Ended | | Nine Months Ended | |
|---|--------------------|------------|-------------------|------------|
| | September 30, | | September 30, | |
| | 2015 | 2014 | 2015 | 2014 |
| Cost of revenues | \$ 2,285 | \$ 1,418 | \$ 6,519 | \$ 3,816 |
| Operating expenses | 5,806 | 3,850 | 16,486 | 9,905 |
| Total stock-based compensation before tax | \$ 8,091 | \$ 5,268 | \$ 23,005 | \$ 13,721 |
| Income tax benefit | \$ (2,326) | \$ (1,395) | \$ (6,437) | \$ (3,977) |

During the nine months of 2015, the Company issued approximately 825,000 shares of common stock to its employees and 31,000 shares to its non-employee directors under the Company's share-based compensation plans.

During the nine months of 2015, the Company granted approximately 1,775,000 restricted stock units (RSUs) and 2,197,000 non-qualified stock options to its employees with total fair values of approximately \$35.8 million and \$16.6 million, respectively. Approximately 250,000 RSUs were granted in connection with the election by employees to receive 50% of their 2015 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 \$4.3 million associated with this RSU grant will be recognized over a one-year period beginning on the grant date.

The Company recognizes stock based compensation on the accelerated recognition method, while treating each vesting tranche as if it were an individual grant. As of September 30, 2015, the Company had approximately \$37 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 2.2 years.

Table of Contents**11. 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 and RSUs, 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 anti-dilutive in the periods presented, but could be dilutive in the future.

| (in thousands, except per share amounts) | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|-------------------------------------|----------|------------------------------------|-----------|
| | 2015 | 2014 | 2015 | 2014 |
| Basic | | | | |
| Net income | \$ 6,325 | \$ 1,882 | \$ 15,364 | \$ 13,151 |
| Weighted-average common shares outstanding | 76,534 | 76,351 | 76,521 | 76,312 |
| Earnings per share, basic | \$ 0.08 | \$ 0.02 | \$ 0.20 | \$ 0.17 |
| Diluted | | | | |
| Net income | \$ 6,325 | \$ 1,882 | \$ 15,364 | \$ 13,151 |
| Weighted-average common shares outstanding, basic | 76,534 | 76,351 | 76,521 | 76,312 |
| Weighted-average effect of dilutive securities: | | | | |
| Stock options | 1,603 | 1,730 | 1,546 | 1,754 |
| RSUs | 1,037 | 572 | 839 | 465 |
| Effect of assumed exercise of stock options and RSUs | 2,640 | 2,302 | 2,385 | 2,219 |
| Weighted-average common shares outstanding, diluted | 79,174 | 78,653 | 78,906 | 78,531 |
| Earnings per share, diluted | \$ 0.08 | \$ 0.02 | \$ 0.19 | \$ 0.17 |
| Outstanding options and RSUs excluded as impact would be anti-dilutive | 320 | 107 | 201 | 110 |

Table of Contents**12. GEOGRAPHIC INFORMATION AND MAJOR CLIENTS**

Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker (CODM) in deciding how to allocate resources and in assessing performance.

The Company develops and licenses its strategic software applications and Pega 7 platform, and provides consulting services, maintenance, and training related to its offerings. 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 CODM reviews financial information on a consolidated basis. Therefore, the Company determined it has one reportable segment – Digital Enterprise Business Solutions, and one reporting unit.

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

| (Dollars in thousands) | Three Months Ended September 30, | | | | Nine Months Ended September 30, | | | |
|------------------------|-------------------------------------|------|------------|------|------------------------------------|------|------------|------|
| | 2015 | | 2014 | | 2015 | | 2014 | |
| U.S. | \$ 89,640 | 55% | \$ 77,792 | 57% | \$ 267,671 | 56% | \$ 230,220 | 55% |
| Other Americas | 6,602 | 4% | 12,195 | 9% | 46,278 | 10% | 21,499 | 5% |
| United Kingdom | 19,491 | 12% | 19,098 | 14% | 60,867 | 13% | 72,655 | 17% |
| Other EMEA | 20,672 | 13% | 15,910 | 11% | 55,376 | 11% | 66,218 | 16% |
| Asia Pacific | 25,998 | 16% | 12,636 | 9% | 48,148 | 10% | 30,488 | 7% |
| | \$ 162,403 | 100% | \$ 137,631 | 100% | \$ 478,340 | 100% | \$ 421,080 | 100% |

There were no clients accounting for 10% or more of the Company’s total revenue during the third quarter and nine months of 2015 and 2014. There were no clients accounting for 10% or more of the Company’s total outstanding trade receivables as of September 30, 2015 and December 31, 2014.

Table of Contents

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations
Forward-Looking Statements**

This Quarterly Report on Form 10-Q contains or incorporates forward-looking statements within the meaning of 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, strategy, is intended to, variations of such words and similar expressions are intended to identify such forward-looking statements. These statements are not guarantees of future performance and involve certain risks, uncertainties, and assumptions that are difficult to predict. 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 consolidation in the financial services, insurance, healthcare, and communications markets; reliance on third party relationships; the potential loss of vendor specific objective evidence for our consulting services; the inherent risks associated with international operations and the continued weakness in international economies; foreign currency exchange rates; the financial impact of the Company's past acquisitions and any future acquisitions; 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, 2014. We do not intend to update any forward-looking statements publicly, whether as a result of new information, future events, or otherwise.

Business overview

We develop, market, license, and support strategic software applications for marketing, sales and onboarding, customer service, and operations. In addition, we license our Pega 7 platform for clients that wish to build and extend their own applications. Pega 7 assists our clients in building, deploying, and evolving 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. We also provide consulting services, maintenance, and training for our software and our applications. Our applications and Pega 7 can be deployed in the Cloud or on-premises.

Pega 7 and our related applications are used by our clients in the financial services, healthcare, insurance, communications and media, public sector, manufacturing, life sciences, and other markets. We sell our software directly and also through a network of business and technology alliances. Our partners include major systems integrators, management consulting firms, technology providers, and application developers.

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. We license our products and render consulting and training services to clients domestically and internationally, including in Canada, Europe, the Middle East, Latin America, Asia, and Australia. In the third quarter of 2015 and 2014, revenue from clients based outside of the United States of America (U.S.) represented 45% and 43% of our total revenue, respectively. In the nine months of 2015 and 2014, revenue from clients based outside of the U.S. represented 44% and 45% of our total revenue, respectively.

Our license revenue is primarily derived from sales of our applications. Our consulting services revenue is primarily related to new license implementations. Our consulting services revenue may be lower in future periods as more of our clients become enabled and our partners lead more projects. We offer training for our staff, clients, and partners at our regional training facilities and at third-party facilities, including client sites. Our online training through Pega Academy provides an alternative way to learn our software in a virtual environment. We believe that this online training will continue to expand the number of trained experts at a faster pace.

We continue to invest heavily in research and development to enhance our software. Our research and development operations are primarily located in the U.S. and India. We also regularly evaluate acquisitions or investment opportunities in complementary businesses, services and technologies, and intellectual property rights in an effort to expand and enhance our product offerings.

Table of Contents

| (Dollars in thousands, except per share amounts) | Three Months Ended September 30, | | Increase | | Nine Months Ended September 30, | | Increase (Decrease) | |
|--|-------------------------------------|------------|-----------|------|------------------------------------|------------|---------------------|-------|
| | 2015 | 2014 | | | 2015 | 2014 | | |
| Total revenue | \$ 162,403 | \$ 137,631 | \$ 24,772 | 18% | \$ 478,340 | \$ 421,080 | \$ 57,260 | 14% |
| License revenue | \$ 58,948 | \$ 48,292 | \$ 10,656 | 22% | \$ 180,420 | \$ 154,918 | \$ 25,502 | 16% |
| Diluted earnings per share | \$ 0.08 | \$ 0.02 | \$ 0.06 | 300% | \$ 0.19 | \$ 0.17 | \$ 0.02 | 12% |
| Cash flow provided by operating activities | | | | | \$ 54,928 | \$ 98,267 | \$ (43,339) | (44)% |

In addition to the key financial metrics in the above table, management also focuses on aggregate license and Cloud backlog. We compute license and Cloud backlog by adding billed deferred license and Cloud revenue as recorded on the balance sheet and license and Cloud contractual commitments, which are not billed and not recorded on our balance sheet. License and Cloud 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, term and Cloud license arrangements.

| (Dollars in thousands) | As of September 30, | | % Change |
|--|---------------------|-------------------|------------|
| | 2015 | 2014 | |
| Total License and Cloud deferred revenue | \$ 55,370 | \$ 68,561 | (19)% |
| Total License and Cloud commitments not on the balance sheet | 324,340 | 265,309 | 22% |
| Total License and Cloud Backlog | \$ 379,710 | \$ 333,870 | 14% |

Critical accounting policies

Management's Discussion and Analysis of Financial Condition and Results of Operations is based upon our unaudited 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 with 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 the 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, 2014. For more information regarding our critical accounting policies, we encourage you to read the discussion contained in Item 7 under the heading "Critical Accounting Estimates and Significant Judgments" 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, 2014.

Table of Contents**Results of Operations**

| (Dollars in thousands) | Three Months Ended | | | | Nine Months Ended | | | |
|--|--------------------|------------|-----------|------|-------------------|------------|-----------|-----|
| | September 30, | | Increase | | September 30, | | Increase | |
| | 2015 | 2014 | | | 2015 | 2014 | | |
| Total revenue | \$ 162,403 | \$ 137,631 | \$ 24,772 | 18% | \$ 478,340 | \$ 421,080 | \$ 57,260 | 14% |
| Gross profit | \$ 106,962 | \$ 91,249 | \$ 15,713 | 17% | \$ 318,059 | \$ 282,094 | \$ 35,965 | 13% |
| Total operating expenses | \$ 96,251 | \$ 86,252 | \$ 9,999 | 12% | \$ 290,189 | \$ 260,248 | \$ 29,941 | 12% |
| Income from operations | \$ 10,711 | \$ 4,997 | \$ 5,714 | 114% | \$ 27,870 | \$ 21,846 | \$ 6,024 | 28% |
| Income before provision for income taxes | \$ 10,246 | \$ 2,352 | \$ 7,894 | 336% | \$ 24,007 | \$ 19,280 | \$ 4,727 | 25% |

Revenue

| (Dollars in thousands) | Three Months Ended | | | | | Nine Months Ended | | | | | | |
|------------------------|--------------------|------|---------------------|------|-----------|-------------------|------------|-----------|------------|-----------|-----------|-----|
| | September 30, | | Increase (Decrease) | | | September 30, | | Increase | | | | |
| | 2015 | 2014 | | | 2015 | 2014 | | | | | | |
| License revenue | | | | | | | | | | | | |
| Perpetual licenses | \$ 40,455 | 69% | \$ 27,338 | 57% | \$ 13,117 | \$ 103,547 | 57% | \$ 83,995 | 54% | \$ 19,552 | | |
| Term licenses | 16,556 | 28% | 19,220 | 40% | (2,664) | 70,778 | 39% | 65,086 | 42% | 5,692 | | |
| Subscription | 1,937 | 3% | 1,734 | 3% | 203 | 6,095 | 4% | 5,837 | 4% | 258 | | |
| Total license revenue | \$ 58,948 | 100% | \$ 48,292 | 100% | \$ 10,656 | 22% | \$ 180,420 | 100% | \$ 154,918 | 100% | \$ 25,502 | 16% |

The aggregate value of new license arrangements executed during the third quarter of 2015 significantly increased compared to the same period of 2014, primarily due to the higher average value of arrangements executed in the third quarter of 2015. The aggregate value of new license arrangements executed during the nine months of 2015 significantly increased compared to the same period of 2014, primarily due to a higher number and higher average value of arrangements executed in the nine months of 2015. The higher average value was due to two arrangements, each greater than \$10 million, executed in the nine months of 2015. The aggregate value of new license arrangements executed fluctuates quarter to quarter. During the nine months of 2015 and 2014, approximately 62% and 86%, 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. Additionally, 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 increases in perpetual license revenue during the third quarter and nine months of 2015 compared to the same periods in 2014 were primarily due to revenue recognized from the higher volume and higher average value of arrangements executed during the nine months of 2015. The aggregate value of payments due under noncancellable perpetual licenses was \$36.5 million as of September 30, 2015 compared to \$15.3 million as of September 30, 2014. We expect to recognize \$5.5 million of the \$36.5 million as revenue in the fourth quarter of 2015.

The fluctuations in term license revenue during the third quarter and nine months of 2015 compared to the same periods in 2014 were primarily due to the prepayment of a large renewal in the second quarter of 2015. The aggregate value of payments due under noncancellable term licenses and our Cloud arrangements grew to \$287.9 million as of September 30, 2015 compared to \$250 million as of September 30, 2014. We expect to recognize \$22.4 million of the \$287.9 million as revenue in the fourth quarter of 2015 in addition to new term license and Cloud arrangements we may complete or prepayments we may receive from existing term license agreements. See the table of future cash receipts in Liquidity and Capital Resources - Cash Provided by Operating Activities.

Subscription revenue primarily consists of the ratable recognition of license, maintenance, and bundled services revenue on license arrangements that include a right to successor products or unspecified future products. Subscription revenue does not include revenue from our Cloud arrangements, which is included in services revenue. The timing of scheduled payments under

Table of Contents

client arrangements may limit the amount of revenue recognized in a reporting period. Consequently, our subscription revenue may vary materially quarter to quarter.

| (Dollars in thousands) | Three Months Ended September 30, | | Increase | | Nine Months Ended September 30, | | Increase | |
|----------------------------|-------------------------------------|-----------|----------|-----|------------------------------------|------------|-----------|----|
| | 2015 | 2014 | | | 2015 | 2014 | | |
| Maintenance revenue | | | | | | | | |
| Maintenance | \$ 52,285 | \$ 47,281 | \$ 5,004 | 11% | \$ 150,366 | \$ 137,555 | \$ 12,811 | 9% |

The increases were primarily due to the growth in the aggregate value of the installed base of our software and continued strong renewal rates.

| (Dollars in thousands) | Three Months Ended September 30, | | Increase (Decrease) | | Nine Months Ended September 30, | | Increase | | | | | |
|-------------------------|-------------------------------------|------|------------------------|------|------------------------------------|------|------------|------|------------|------|-----------|-----|
| | 2015 | 2014 | | | 2015 | 2014 | | | | | | |
| Services revenue | | | | | | | | | | | | |
| Consulting services | \$ 41,472 | 81% | \$ 35,951 | 85% | \$ 5,521 | 15% | \$ 121,810 | 83% | \$ 112,862 | 88% | \$ 8,948 | 8% |
| Cloud | 8,244 | 16% | 4,561 | 11% | 3,683 | 81% | 21,700 | 15% | 12,146 | 9% | 9,554 | 79% |
| Training | 1,454 | 3% | 1,546 | 4% | (92) | (6)% | 4,044 | 2% | 3,599 | 3% | 445 | 12% |
| Total services | \$ 51,170 | 100% | \$ 42,058 | 100% | \$ 9,112 | 22% | \$ 147,554 | 100% | \$ 128,607 | 100% | \$ 18,947 | 15% |

Consulting services represents revenue primarily from new license implementations. Our consulting services revenue may fluctuate in future periods depending on the mix of new implementation projects we perform as compared to those performed by our enabled clients or led by our partners. The increases in consulting services revenue were due to the higher number of projects and billable hours in the third quarter and nine months of 2015 compared to the same periods in 2014.

Cloud represents revenue from our Cloud offerings. The increases in Cloud revenue were primarily due to continued growth of our Cloud client base.

Gross profit

| (Dollars in thousands) | Three Months Ended September 30, | | Increase | Nine Months Ended September 30, | | Increase (Decrease) |
|------------------------|-------------------------------------|------|----------|------------------------------------|------|------------------------|
| | 2015 | 2014 | | 2015 | 2014 | |

| Gross Profit | | | | | | | | |
|---------------------------------|-------------------|------------------|------------------|------------|-------------------|-------------------|------------------|------------|
| Software license | \$ 57,948 | \$ 47,216 | \$ 10,732 | 23% | \$ 177,314 | \$ 151,086 | \$ 26,228 | 17% |
| Maintenance | 46,641 | 41,896 | 4,745 | 11% | 134,066 | 122,462 | 11,604 | 9% |
| Services | 2,373 | 2,137 | 236 | 11% | 6,679 | 8,546 | (1,867) | (22)% |
| Total gross profit | \$ 106,962 | \$ 91,249 | \$ 15,713 | 17% | \$ 318,059 | \$ 282,094 | \$ 35,965 | 13% |
| Total gross profit % | 66% | 66% | | | 66% | 67% | | |
| Software license gross profit % | 98% | 98% | | | 98% | 98% | | |
| Maintenance gross profit % | 89% | 89% | | | 89% | 89% | | |
| Services gross profit % | 5% | 5% | | | 5% | 7% | | |

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

The decrease in services gross profit percent during the nine months of 2015 compared to the nine months of 2014 was primarily due to increased software license costs and significant cost overruns on two North American projects.

Table of Contents**Operating expenses**

| (Dollars in thousands) | Three Months Ended | | Increase (Decrease) | | Nine Months Ended | | Increase (Decrease) | |
|-------------------------------------|--------------------|--------------------|---------------------|-------|--------------------|--------------------|---------------------|-------|
| | September 30, 2015 | September 30, 2014 | | | September 30, 2015 | September 30, 2014 | | |
| Amortization of intangibles: | | | | | | | | |
| Cost of revenue | \$ 1,351 | \$ 1,382 | \$ (31) | (2)% | \$ 4,041 | \$ 4,666 | \$ (625) | (13)% |
| Selling and marketing | 1,537 | 1,501 | 36 | 2% | 4,602 | 4,496 | 106 | 2% |
| General and administrative | 91 | 574 | (483) | (84)% | 593 | 1,475 | (882) | (60)% |
| | \$ 2,979 | \$ 3,457 | \$ (478) | (14)% | \$ 9,236 | \$ 10,637 | \$ (1,401) | (13)% |

The decreases were primarily due to the full amortization in 2014 of certain acquired technology and other intangibles.

| (Dollars in thousands) | Three Months Ended | | Increase | | Nine Months Ended | | Increase | |
|--|--------------------|--------------------|----------|-----|--------------------|--------------------|-----------|-----|
| | September 30, 2015 | September 30, 2014 | | | September 30, 2015 | September 30, 2014 | | |
| Selling and marketing | | | | | | | | |
| Selling and marketing | \$ 53,640 | \$ 48,623 | \$ 5,017 | 10% | \$ 169,764 | \$ 150,772 | \$ 18,992 | 13% |
| As a percent of total revenue | 33% | 35% | | | 35% | 36% | | |
| Selling and marketing headcount at September 30, | | | | | 707 | 637 | 70 | 11% |

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 2015 compared to the same period in 2014 was primarily due to a \$3.7 million increase in compensation and benefits associated with higher headcount and a \$1 million increase in sales and marketing program expenses.

The increase in selling and marketing expenses during the nine months of 2015 compared to the same period in 2014 was primarily due to a \$9.4 million increase in compensation and benefits associated with higher headcount, a \$7 million increase in marketing and sales program expenses, and a \$3.1 million increase in sales commissions associated with the higher value of new license arrangements executed during the nine months of 2015 compared to the nine months of 2014.

| (Dollars in thousands) | Three Months Ended September 30, | | Increase | Nine Months Ended September 30, | | Increase |
|---------------------------------|-------------------------------------|-----------|--------------|------------------------------------|-----------|---------------|
| | 2015 | 2014 | | 2015 | 2014 | |
| Research and development | | | | | | |
| Research and development | \$ 33,032 | \$ 28,558 | \$ 4,474 16% | \$ 94,248 | \$ 80,490 | \$ 13,758 17% |
| As a percent of total revenue | 20% | 21% | | 20% | 19% | |

Research and development headcount at September 30, 1,189 1,046 143 14%

Research and development expenses include compensation, benefits, contracted services, and other headcount-related expenses associated with the creation and development of our products as well as enhancements and engineering changes to existing products.

The increase in headcount reflects the growth in our India research facility. The increase in offshore headcount lowered our average compensation expense per employee.

The increase in research and development expenses during the third quarter of 2015 compared to the same period in 2014 was primarily due to a \$2.9 million increase in compensation and benefit expenses associated with higher headcount, a \$0.5 million increase in outsourced hosting services, a \$0.3 million increase in equipment and software license costs, and a \$0.2 million increase in contracted professional services.

Table of Contents

The increase in research and development expenses during the nine months of 2015 compared to the same period in 2014 was primarily due to a \$8.7 million increase in compensation and benefit expenses associated with higher headcount, a \$1.2 million increase in outsourced hosting services, a \$1.1 million increase in equipment and software license costs, and a \$0.9 million increase in contracted professional services.

| (Dollars in thousands) | Three Months Ended September 30, | | Increase | | Nine Months Ended September 30, | | Increase (Decrease) | |
|---|-------------------------------------|----------|----------|----|------------------------------------|-----------|---------------------|------|
| | 2015 | 2014 | | | 2015 | 2014 | | |
| General and administrative | | | | | | | | |
| General and administrative | \$ 9,579 | \$ 8,825 | \$ 754 | 9% | \$ 26,138 | \$ 28,377 | \$ (2,239) | (8)% |
| As a percent of total revenue | 6% | 6% | | | 5% | 7% | | |
| General and administrative headcount at September 30, | | | | | 327 | 298 | 29 | 10% |

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.

The increase in general and administrative expenses during the third quarter of 2015 compared to the same period in 2014 was primarily due to a \$0.8 million increase in compensation and benefit expenses associated with higher headcount.

The decrease in general and administrative expenses during the nine months of 2015 compared to the same period in 2014 was primarily due to the recognition in the first quarter of 2015 of the \$1.8 million benefit from the settlement of the Antenna indemnification claims and the \$1.6 million benefit from the settlement of indirect tax liabilities, and a decrease in amortization expense of \$0.9 million due to the full amortization of certain Antenna intangibles in the fourth quarter of 2014, partially offset by a \$2 million increase in compensation and benefit expenses associated with higher headcount.

Stock-based compensation

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

| | Three Months Ended September 30, | Increase | Nine Months Ended September 30, | Increase |
|--|-------------------------------------|----------|------------------------------------|----------|
|--|-------------------------------------|----------|------------------------------------|----------|

| (Dollars in thousands) | 2015 | | 2014 | | 2015 | | 2014 | |
|---|-------------|------------|-------------|-----|-------------|------------|-------------|-----|
| Cost of revenues | \$ 2,285 | \$ 1,418 | \$ 867 | 61% | \$ 6,519 | \$ 3,816 | \$ 2,703 | 71% |
| Operating expenses | 5,806 | 3,850 | 1,956 | 51% | 16,486 | 9,905 | 6,581 | 66% |
| Total stock-based compensation before tax | \$ 8,091 | \$ 5,268 | \$ 2,823 | 54% | \$ 23,005 | \$ 13,721 | \$ 9,284 | 68% |
| Income tax benefit | \$ (2,326) | \$ (1,395) | | | \$ (6,437) | \$ (3,977) | | |

The increases were primarily due to the higher value of the 2014 annual periodic equity grant compared to the 2013 grant, which occurred in March 2015 and 2014, respectively.

Non-operating income and expenses, net

| (Dollars in thousands) | Three Months Ended | | Increase (Decrease) | | Nine Months Ended | | Increase (Decrease) | |
|-----------------------------------|---------------------------|---------------------------|----------------------------|-------|---------------------------|---------------------------|----------------------------|-------|
| | September 30, 2015 | September 30, 2014 | | | September 30, 2015 | September 30, 2014 | | |
| Foreign currency transaction loss | \$ (412) | \$ (2,845) | \$ 2,433 | (86)% | \$ (4,342) | \$ (2,527) | \$ (1,815) | 72% |
| Interest income, net | 278 | 181 | 97 | 54% | 807 | 468 | 339 | 72% |
| Other (expense) income, net | (331) | 19 | (350) | n/m | (328) | (507) | 179 | (35)% |
| Non-operating loss | \$ (465) | \$ (2,645) | \$ 2,180 | (82)% | \$ (3,863) | \$ (2,566) | \$ (1,297) | 51% |

n/m - not meaningful

Table of Contents

We have historically used foreign currency forward contracts (forward contracts) to manage our exposure to changes in foreign currency exchange rates associated with cash, accounts receivable, and intercompany receivables and payables held by Pegasystems Inc., our U.S. operating company, in currencies other than the U.S. dollar.

Effective on April 1, 2015, our clients based outside the Americas began transacting with Pegasystems Limited, a U.K. subsidiary, which has the British pound as its functional currency. This reorganization resulted in increased cash, accounts receivable, and intercompany receivables and payables held by Pegasystems Limited in currencies other than the British pound.

We did not enter into any forward contracts between March 2014 and June 2015. In the third quarter of 2015, as a result of this operational reorganization, we implemented our revised hedging program, under which we fully or partially hedge our non-functional currency exposures for Pegasystems Inc. and Pegasystems Limited, utilizing forward contracts with terms not greater than six months.

These forward contracts are not designated as hedging instruments. 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) income, net.

See Note 4 Derivative Instruments in the notes to the accompanying unaudited condensed consolidated financial statements for discussion of our use of forward contracts.

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 2015 and 2014, we recorded tax provisions of \$3.9 million and \$0.5 million, respectively, which resulted in an effective tax rate of 38.3% and 20.0%, respectively. During the nine months of 2015 and 2014, we recorded a provision of \$8.6 million and \$6.1 million, respectively, which resulted in an effective tax rate of 36.0% and 31.8%, respectively. The increases in our effective tax rates during the third quarter and nine months of 2015 compared to the same periods in 2014 were primarily due to a lower proportion of our income being subjected to tax in low tax rate jurisdictions, a decrease in our anticipated domestic production activities deduction, and the fact that the research and experimentation credit has not yet been extended to 2015.

Liquidity and capital resources

| (in thousands) | Nine Months Ended | |
|---------------------------------|-------------------|-----------|
| | September 30, | |
| | 2015 | 2014 |
| Cash provided by (used in): | | |
| Operating activities | \$ 54,928 | \$ 98,267 |
| Investing activities | (42,736) | (22,485) |
| Financing activities | (25,662) | (17,403) |
| Effect of exchange rate on cash | (3,837) | (2,065) |

| | | |
|--|-------------|-----------|
| Net (decrease) increase in cash and cash equivalents | \$ (17,307) | \$ 56,314 |
|--|-------------|-----------|

| | As of September 30, 2015 | As of December 31, 2014 |
|---|-------------------------------------|------------------------------------|
| Total cash, cash equivalents, and marketable securities | \$ 224,016 | \$ 211,216 |

The decrease in cash and cash equivalents during the nine months of 2015 was primarily due to cash used in investing and financing activities. We believe that our current cash, cash equivalents, marketable securities, 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. During the nine months of 2014, we paid \$0.8 million of the remaining merger consideration related to the final working capital adjustment for our October 2013 acquisition of Antenna Software, Inc., \$0.8 million in cash consideration to acquire Meshlabs Software Private Limited, and \$1.2 million representing the closing cash consideration to acquire Profeatable Corporation, inclusive of \$0.2 million in cash acquired. During the nine months of 2015, we paid \$1.1 million representing the remaining cash

Table of Contents

consideration to the selling shareholders of one of the three companies acquired in 2014 and \$0.5 million in additional cash consideration to the selling shareholders of another one of the three companies acquired in 2014 based on the achievement of certain performance milestones. We may be required to pay an additional \$1.2 million in cash to the same selling shareholders based on the achievement of additional performance milestones through the end of 2016.

As of September 30, 2015, approximately \$51.9 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. 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 nine months of 2015 were net income of \$15.4 million and \$23 million of stock-based compensation expense.

The primary drivers of cash provided by operating activities during the nine months of 2014 were net income of \$13.2 million and a \$56.4 million net change in assets and liabilities. The net change in assets and liabilities primarily consisted of a decrease in trade accounts receivable due to our significant collections, partially offset by an increase in income taxes receivable due to estimated tax payments and the tax benefits associated with domestic stock-based compensation expense.

Future Cash Receipts from License and Cloud Arrangements

Total contractual future cash receipts due from our existing license and Cloud arrangements was approximately \$324.3 million as of September 30, 2015, compared to \$265.3 million as of September 30, 2014. The future cash receipts due are summarized as follows:

| (in thousands) as of September 30, 2015 | Contractual payments for term licenses and Cloud arrangements not recorded on the balance sheet ⁽¹⁾ | Other contractual license payments not recorded on the balance sheet ⁽²⁾ | Total |
|---|---|--|-------------------|
| Remainder of 2015 | \$ 22,362 | \$ 5,480 | \$ 27,842 |
| 2016 | 107,287 | 20,795 | 128,082 |
| 2017 | 66,903 | 6,481 | 73,384 |
| 2018 | 49,825 | 3,076 | 52,901 |
| 2019 and thereafter | 41,486 | 645 | 42,131 |
| Total | \$ 287,863 | \$ 36,477 | \$ 324,340 |

- (1) These amounts include contractual future cash receipts related to our on-premises term licenses and hosted Cloud service offerings. The timing of future revenue recognition and future cash receipts may not coincide.
- (2) These amounts include contractual future cash receipts related to perpetual licenses with extended payment terms and/or additional rights of use.

Cash used in investing activities

During the nine months of 2015, cash used in investing activities was primarily for purchases of marketable debt securities of \$66.9 million, partially offset by the proceeds received from the maturities of marketable debt securities of \$33.9 million.

During the nine months of 2014, cash used in investing activities was primarily for purchases of marketable debt securities of \$36.2 million, partially offset by the proceeds received from the maturities of marketable debt securities of \$22.2 million.

Cash used in financing activities

Cash used in financing activities during the nine months of 2015 and 2014 was primarily for repurchases of our common stock. Since 2004, our Board of Directors has approved annual stock repurchase programs that have authorized the repurchase in the aggregate of up to \$169 million of our common stock. On June 4, 2015, we announced that our Board of Directors extended the expiration date of the current stock repurchase program to June 30, 2016 and authorized the Company to repurchase an

Table of Contents

additional \$50 million of our stock between June 4, 2015 and June 30, 2016. 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 nine months of 2015 and 2014:

| (Dollars in thousands) | Nine Months Ended September 30, | | | |
|---|--|---------------|---------------|---------------|
| | 2015 | | 2014 | |
| | Shares | Amount | Shares | Amount |
| Prior year authorization as of January 1, | | \$ 13,284 | | \$ 14,433 |
| Authorizations | | 50,000 | | |
| Repurchases paid | 727,591 | (16,705) | 598,273 | (12,112) |
| Repurchases unsettled | 20,946 | (510) | 10,125 | (197) |
| Authorization remaining as of September 30, | | \$ 46,069 | | \$ 2,124 |

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.

During the nine months of 2015 and 2014, option and RSU holders net settled a total of 1,422,000 shares and 948,000 shares, respectively, of which only 745,000 shares and 529,000 shares, respectively, were issued to the option and RSU holders. The balance of the shares were surrendered to us to pay for the exercise price and the applicable taxes. During the nine months of 2015 and 2014, instead of receiving cash from the equity holders, we withheld shares with a value of \$7.1 million and \$4.9 million, respectively, for withholding taxes, and \$8.5 million and \$4.9 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 nine months of 2015 and 2014.

Dividends

On May 27, 2014, we announced an increase in our quarterly cash dividend from \$0.015 to \$0.03 per share. We declared a cash dividend of \$0.09 and \$0.075 in the nine months of 2015 and 2014, respectively. We paid cash dividends of \$6.9 million and \$4.6 million in the nine months of 2015 and 2014, respectively. 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.

Table of Contents

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Market risk represents the risk of loss that may affect us due to adverse changes in financial market prices and rates. Our market risk exposure is primarily related to fluctuations in foreign exchange rates.

We have historically used foreign currency forward contracts (forward contracts) to manage our exposure to changes in foreign currency exchange rates associated with cash, accounts receivable, and intercompany receivables and payables held by Pegasystems Inc., our U.S. operating company, in currencies other than the U.S. dollar.

Effective on April 1, 2015, our clients based outside the Americas began transacting with Pegasystems Limited, a U.K. subsidiary, which has the British pound as its functional currency. This reorganization resulted in increased cash, accounts receivable, and intercompany receivables and payables held by Pegasystems Limited in currencies other than the British pound.

We did not enter into any forward contracts between March 2014 and June 2015. In the third quarter of 2015, as a result of this operational reorganization, we implemented our revised hedging program, under which we fully or partially hedge our non-functional currency exposures for Pegasystems Inc. and Pegasystems Limited, utilizing forward contracts with terms not greater than six months.

See Note 4 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 nine months of 2015. 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, 2014 for a more complete discussion of our market risk exposure.

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

Our management, with the participation of our Chief Executive Officer, or CEO, and Chief Financial Officer, or CFO, evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act) as of September 30, 2015. 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, 2015.

(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, 2015 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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

We encourage you to carefully consider the risk factors identified in Part I, Item 1A. Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2014. These risk factors could materially affect our business, financial condition, and future results and could cause our actual business and financial results to differ materially from those contained in forward-looking statements made in this Quarterly Report on Form 10-Q or elsewhere by management from time to time. There have been no material changes during the nine months of 2015 to the risk factors disclosed in our Annual Report on Form 10-K for the year ended December 31, 2014.

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 2015:

| Period | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as of Publicly Announced Programs (1) | | Approximate Dollar Value of Shares That May Yet Be Purchased Under Publicly Announced Programs (1) | |
|----------------------|--|------------------------------------|--|-------------------------------------|--|-------------------------------------|
| | | | Share Repurchase Programs (1) | Share Repurchase Programs (1) | Share Repurchase Programs (1) | Share Repurchase Programs (1) |
| 7/1/2015 - 7/31/2015 | 189,025 | \$ 23.40 | 189,025 | \$ | 51,332 | |

Edgar Filing: PEGASYSTEMS INC - Form 10-Q

| | | | | | | |
|----------------------|---------|----|-------|---------|----|--------|
| 8/1/2015 - 8/31/2015 | 72,718 | \$ | 25.16 | 72,718 | \$ | 49,503 |
| 9/1/2015 - 9/30/2015 | 139,473 | \$ | 24.62 | 139,473 | \$ | 46,069 |
| Total | 401,216 | \$ | 24.14 | | | |

- (1) Since 2004, our Board of Directors has approved stock repurchase programs that have authorized the repurchase, in the aggregate, of up to \$169 million of our common stock. On June 4, 2015, we announced that our Board of Directors extended the expiration date of the current stock repurchase program to June 30, 2016 and authorized the Company to repurchase an additional \$50 million of our stock between June 4, 2015 and June 30, 2016 (the Current Program). Under 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 (the Exchange Act), and Rule 10b-18 under 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.

Table of Contents

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.

Table of Contents

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: October 27, 2015

By: /s/ RAFEAL E. BROWN
Rafeal E. Brown

**Chief Financial Officer, Chief Administrative
Officer and Senior Vice President
(Principal Financial Officer)**

Table of Contents

PEGASYSTEMS INC.

Exhibit Index

| Exhibit No. | Description |
|--------------------|--|
| 10.1+ | Compensation program for non-employee members of the Registrant's Board of Directors, effective August 6, 2015. |
| 10.2 | First Amendment to Lease Agreement dated November 11, 2014 between Charles Park One, LLC and Pegasystems Inc. |
| 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 ended September 30, 2015 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. |
| + | Management contracts and compensatory plans or arrangements. |