PEGASYSTEMS INC
Form 10-Q
November 09, 2010
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

x **Quarterly Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the quarterly period ended September 30, 2010

or

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

Commission File Number: 1-11859

PEGASYSTEMS INC.

(Exact name of Registrant as specified in its charter)

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

(617) 374-9600

(Registrant s telephone number including area code)

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

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

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

Large accelerated filer ¨	Accelerated filer x	Non-accelerated filer ¨ (Do not check if smaller reporting company)	Smaller reporting company ¨

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

There were 37,037,619 shares of the Registrant s common stock, $.01 par value per share, outstanding on October 29, 2010.

Table of Contents

PEGASYSTEMS INC.

Index to Form 10-Q

		Page
Part I. Financial Information		
Item 1.	Financial Statements:	
	Unaudited Condensed Consolidated Balance Sheets as of September 30, 2010 and December 31, 2009	3
	Unaudited Condensed Consolidated Statements of Operations for the three and nine months ended September 30, 2010 and 2009	4
	Unaudited Condensed Consolidated Statements of Cash Flows for the nine months ended September 30, 2010 and 2009	5
	Notes to Unaudited Condensed Consolidated Financial Statements	6
Item 2.	Management s Discussion and Analysis of Financial Condition and Results of Operations	17
Item 3.	Quantitative and Qualitative Disclosures About Market Risk	32
Item 4.	Controls and Procedures	33
Part II. Other Information		
Item 1A.	Risk Factors	33
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds	33
Item 6.	Exhibits	34
SIGNATURE		35

Table of Contents

PEGASYSTEMS INC.

UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands)

	As of September 30, 2010	As of December 31, 2009
ASSETS		
Current assets:		
Cash and cash equivalents	$ 52,777	$ 63,857
Marketable securities	16,076	138,796
Total cash, cash equivalents, and marketable securities	68,853	202,653
Trade accounts receivable, net of allowance of $1,188 and $649	75,952	39,396
Short-term license installments	2,447	2,829
Deferred income taxes	6,516	2,523
Income taxes receivable and other current assets	17,010	8,840
Total current assets	170,778	256,241
Long-term license installments, net	1,383	2,976
Property and equipment, net	10,769	8,931
Long-term deferred income taxes	30,521	7,515
Other assets	2,489	1,195
Intangible assets, net	83,554	336
Goodwill	21,613	2,391
Total assets	$ 321,107	$ 279,585
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 5,445	$ 4,791
Accrued expenses	26,417	6,748
Accrued compensation and related expenses	23,746	23,280
Deferred revenue	48,773	32,870
Total current liabilities	104,381	67,689
Income taxes payable	6,134	4,828
Other long-term liabilities	5,192	1,849
Total liabilities	115,707	74,366
Commitments and contingencies (Note 9)		
Stockholders equity:		
Preferred stock, 1,000 shares authorized; no shares issued and outstanding		
Common stock and additional paid-in capital, 70,000 shares authorized; 37,048 shares and 36,818 shares issued and outstanding	126,685	121,757
Retained earnings and accumulated other comprehensive income of $1,473 and $1,686	78,715	83,462

Total stockholders equity		205,400		205,219
Total liabilities and stockholders equity	$	321,107	$	279,585

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, 2010	Three Months Ended September 30, 2009	Nine Months Ended September 30, 2010	Nine Months Ended September 30, 2009
Revenue:				
Software license	$ 33,889	$ 28,358	$ 92,432	$ 82,045
Maintenance	23,418	12,489	58,892	36,608
Professional services	32,709	23,974	96,022	72,413
Total revenue	90,016	64,821	247,346	191,066
Cost of revenue:				
Cost of software license	1,571	28	2,711	90
Cost of maintenance	3,187	1,558	7,839	4,452
Cost of professional services	30,232	22,474	82,136	61,641
Total cost of revenue	34,990	24,060	92,686	66,183
Gross profit	55,026	40,761	154,660	124,883
Operating expenses:				
Selling and marketing	31,199	19,568	82,988	51,663
Research and development	14,924	9,930	40,560	28,198
General and administrative	6,442	3,798	18,246	13,392
Acquisition-related costs	111	-	5,014	
Restructuring costs	407	-	6,487	
Total operating expenses	53,083	33,296	153,295	93,253
Income from operations	1,943	7,465	1,365	31,630
Foreign currency transaction gain (loss)	1,513	266	(4,103)	2,377
Interest income, net	129	721	761	2,404
Installment receivable interest income	51	74	155	224
Other income, net	572		814	17
Income (loss) before provision for income taxes	4,208	8,526	(1,008)	36,652
Provision for income taxes	1,069	2,525	190	10,768
Net income (loss)	$ 3,139	$ 6,001	$ (1,198)	$ 25,884

Net earnings (loss) per share:								
Basic	$	0.08	$	0.16	$	(0.03)	$	0.72
Diluted	$	0.08	$	0.16	$	(0.03)	$	0.68
Weighted-average number of common shares outstanding								
Basic		36,996		36,462		37,008		36,035
Diluted		38,534		38,441		37,008		37,955
Cash dividends declared per share	$	0.03	$	0.03	$	0.09	$	0.09

See notes to unaudited condensed consolidated financial statements.

4

Table of Contents

PEGASYSTEMS INC.

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

	Nine Months Ended September 30, 2010	2009
Operating activities:		
Net (loss) income	$ (1,198)	$ 25,884
Adjustment to reconcile net (loss) income to cash (used in) provided by operating activities:		
Excess tax benefits from exercise or vesting of equity awards	(5,456)	(14,409)
Deferred income taxes	(2,088)	(901)
Depreciation, amortization and other non-cash items	7,013	2,021
Amortization of investments and realized gain on sale of investments	671	2,963
Stock-based compensation expense	5,213	3,523
Foreign currency transaction loss	3,775	
Change in operating assets and liabilities:		
Trade accounts receivable	(22,052)	15,093
License installments	1,976	4,586
Income taxes receivable and other current assets	(2,022)	(801)
Accounts payable and accrued expenses	4,971	5,738
Deferred revenue	(281)	(4,413)
Other long-term assets and liabilities	(28)	(445)
Cash (used in) provided by operating activities	(9,506)	38,839
Investing activities:		
Purchases of marketable securities	(67,228)	(49,851)
Matured and called marketable securities	27,280	35,925
Sale of marketable securities	162,226	
Payments for 2010 acquisition, net of cash acquired	(109,228)	
Payments for 2008 acquisition	(250)	
Investment in property and equipment	(4,075)	(3,724)
Cash provided by (used in) investing activities	8,725	(17,650)
Financing activities:		
Proceeds from issuance of common stock for share-based compensation plans	1,546	4,075
Excess tax benefits from exercise or vesting of equity awards	5,456	14,409
Dividend payments to stockholders	(3,330)	(3,245)
Common stock repurchases for tax withholdings for net settlement of equity awards	(4,493)	(7,417)
Repurchase of common stock	(6,098)	(9,893)
Cash used in financing activities	(6,919)	(2,071)
Effect of exchange rate on cash and cash equivalents	(3,380)	1,214
Net (decrease) increase in cash and cash equivalents	(11,080)	20,332

Cash and cash equivalents, beginning of period		63,857		36,087
Cash and cash equivalents, end of period	$	52,777	$	56,419

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

The Company has prepared the accompanying unaudited condensed consolidated financial statements pursuant to the rules and regulations of the Securities and Exchange Commission (SEC) regarding interim financial reporting. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America (U.S.) for complete financial statements and should be read in conjunction with the Company s audited financial statements included in the Annual Report on Form 10-K for the year ended December 31, 2009.

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 2010.

Acquisition-related costs

Acquisition-related costs are expensed as incurred and include costs to effect an impending or completed acquisition and direct and incremental costs associated with an acquisition. During the first nine months of 2010, the Company incurred $5.0 million of acquisition-related costs associated with its acquisition of Chordiant Software, Inc. (Chordiant). These costs consisted of approximately $3.1 million of due diligence costs and advisory and legal transaction fees, approximately $0.7 million of valuation and tax consulting fees, $0.8 million of legal costs associated with the assumed litigation, and $0.4 million of integration and other expenses. See Note 5 Acquisition, Goodwill and Intangibles for further discussion of the acquisition.

Restructuring costs

Restructuring costs include severance and related benefit costs for the reduction of personnel during the second and third quarter of 2010 related to the Chordiant acquisition. See Note 8 Accrued Restructuring Costs for further detail.

2. FAIR VALUE MEASUREMENTS

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 such assumptions, a three-tier fair value hierarchy, which prioritizes 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) inputs other than the quoted prices in active markets that are observable either directly or indirectly; and (Level 3) unobservable inputs in which there is little or no market data, which requires the Company to develop its own assumptions. This hierarchy requires the Company to use observable market data, when available, and to minimize the use of unobservable inputs when determining fair value. On a recurring basis, the Company measures its marketable securities and cash equivalents at fair value and classifies them as follows:

		Fair Value Measurements at Reporting Date Using	
(in thousands)	September 30, 2010	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)
Cash equivalents	$ 1,861	$ 1,861	$
Marketable securities:			
Government sponsored enterprise bonds	$ 7,800	$ 5,798	$ 2,002
Commercial paper	3,991		3,991
Corporate bonds	2,149	2,149	
Municipal bonds	2,136	2,136	
Total marketable securities	$ 16,076	$ 10,083	$ 5,993

		Fair Value Measurements at Reporting Date Using	
(in thousands)	December 31, 2009	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)
Cash equivalents	$ 9,880	$ 9,880	$
Marketable securities:			
Municipal bonds	$ 112,723	$ 27,152	$ 85,571
Government sponsored enterprise bonds	19,560		19,560
Corporate bonds	6,513	6,513	
Total marketable securities	$ 138,796	$ 33,665	$ 105,131

The carrying values of accounts receivable, license installments, and accounts payable approximate their fair value.

Table of Contents

3. TRADE ACCOUNTS RECEIVABLE, NET OF ALLOWANCE

Unbilled trade accounts receivable relate to services earned under time and material arrangements, maintenance and license arrangements that had not been invoiced as of September 30, 2010 and December 31, 2009, respectively.

(in thousands)	As of September 30, 2010	As of December 31, 2009
Trade accounts receivable	$ 61,822	$ 32,042
Unbilled accounts receivable	15,318	8,003
Total accounts receivable	77,140	40,045
Allowance for sales credit memos	(1,021)	(541)
Allowance for doubtful accounts	(167)	(108)
Total allowances	(1,188)	(649)
	$ 75,952	$ 39,396

4. INCOME TAXES RECEIVABLE AND OTHER CURRENT ASSETS

(in thousands)	As of September 30, 2010	As of December 31, 2009
Income tax receivable	$ 11,818	$ 5,046
Prepaid expenses	1,631	1,092
Sales tax receivable	1,761	614
Interest receivable	46	1,664
Other	1,754	424
	$ 17,010	$ 8,840

5. ACQUISITION, GOODWILL, AND INTANGIBLES

Chordiant Acquisition

On April 21, 2010, the Company acquired all of the outstanding shares of common stock of Chordiant, a leading provider of customer relationship management (CRM) software and services with a focus on improving customer experiences through decision technology. The aggregate purchase price for Chordiant was approximately $160.3 million, consisting of $156.8 million in cash and stock options with a fair value of $3.5 million. The Company issued approximately 241,000 stock options as replacement of outstanding Chordiant stock options at the acquisition date. The majority of the fair value of these stock options was recorded as purchase price based on the portion of the awards related to pre-combination services. The compensation expense associated with the portion of the replacement awards related to post-combination services totaled $0.2 million and will be recognized as compensation expense over the remaining service period. The Company has expensed all transaction costs, as described in Note 1 Accounting Policies. These costs have been included in acquisition-related costs in the accompanying condensed consolidated statement of operations.

The Company believes the acquisition will expand its global customer base and provide complementary solutions. Chordiant clients will be able to incorporate Pegasystems process automation to enhance their experience in their existing call center and marketing solutions. Pegasystems clients will benefit from Chordiant s decision management solutions and extensive CRM assets. In addition, the Company believes the combination of the two companies will expand the partner network and provide incremental business opportunity growth.

The operations of Chordiant are included in our operating results from the date of acquisition. Due to the rapid integration of the sales force and operations of Chordiant, other than the maintenance revenue attributable to the amortization of the fair value of acquired deferred revenue, it is no longer feasible for the Company to identify revenue from arrangements attributable to Chordiant.

The valuation of the acquired intangible assets and assumed liabilities is preliminary. The Company is in the process of investigating the facts and circumstances existing as of the acquisition date in order to finalize its valuation and establish the related tax basis. The Company has preliminarily determined that it may utilize approximately $146 million of acquired Chordiant net operating losses (NOLs), which are subject to annual limitations through 2029. As a result of this determination, the Company updated its purchase price allocation in the third quarter of 2010 and recorded a $31.5 million increase in net deferred tax assets, a $0.3 million increase in accrued federal income taxes, a decrease of $2.4 million in acquired intangible assets, and a $29.4 million decrease in goodwill. As of September 30, 2010, as a result of the updated preliminary purchase price allocation, the Company recognized approximately $19.2 million of goodwill, which is primarily due to the expected synergies of the combined entities and the workforce in place. The goodwill created by the transaction is nondeductible for tax purposes. A summary of the preliminary purchase price allocation for the acquisition of Chordiant is as follows:

(in thousands)		
Total purchase consideration:		
Cash	$	156,832
Stock options		3,519
Total purchase consideration	$	160,351
Allocation of the purchase consideration:		
Cash	$	47,604
Accounts receivable, net of allowance		14,231
Other assets		2,661
Property and equipment		753
Deferred tax assets, net		24,784
Identifiable intangible assets		88,049
Goodwill		19,222
Accounts payable		(5,303)
Accrued liabilities		(10,478)
Deferred revenue		(17,863)
Long-term liabilities		(3,309)
Net assets acquired	$	160,351

The valuation of the assumed deferred maintenance revenue was based on the Company s contractual commitment to provide post-contract customer support to Chordiant customers. The fair value of this assumed liability was based on the cost plus a reasonable margin to fulfill these service obligations. The majority of the deferred revenue is expected to be recognized in the 12 months following the acquisition. The valuation of the acquired intangible assets is inherently subjective and relies on significant unobservable inputs. The valuation assumptions take into consideration the Company s estimates of contract renewal, technology attrition and revenue growth projections. The preliminary allocations of the purchase price consideration to tangible and intangible assets acquired were based on our estimates and assumptions that are still subject to change.

Table of Contents

The preliminary values for specifically identifiable intangible assets, by major asset class, are as follows:

(in thousands)		Weighted-average amortization period (in years)
Customer related intangible assets	$ 44,355	9
Technology	43,446	8
Trade name	248	1
	$ 88,049	8.4

Pro forma Information

The following unaudited pro forma financial information presents the combined results of operations of the Company and Chordiant as if the acquisition had occurred on January 1, 2010 and 2009, respectively, after giving effect to certain pro forma adjustments. The pro forma adjustments reflected herein include only those adjustments that are directly attributable to the Chordiant acquisition, factually determinable, and expected to have a continuing impact on the Company. These pro forma adjustments include a reduction of historical Chordiant revenue for fair value adjustments related to acquired deferred revenue and deferred costs, a net increase in amortization expense to eliminate historical amortization of Chordiant intangible assets and to record amortization expense for the $88 million of acquired identifiable intangibles, and a decrease in interest income as a result of the cash paid for the acquisition. The unaudited pro forma financial information does not reflect any adjustments for anticipated synergies resulting from the acquisition and is not necessarily indicative of the operating results that would have actually occurred had the transaction been consummated as of January 1, 2010 and 2009, respectively. The preliminary allocations of the purchase price consideration to tangible and intangible assets acquired and liabilities assumed herein were based upon preliminary valuations and our estimates and assumptions are still subject to change.

	Pro Forma Three Months Ended September 30,		Pro Forma Nine Months Ended September 30,	
	2010	2009	2010	2009
Revenue	$ 90,016	$ 75,814	$ 262,170	$ 232,518
Net income (loss)	3,139	(2,792)	(19,397)	5,021
Net income (loss) per basic share	$ 0.08	$ (0.08)	$ (0.52)	$ 0.14
Net income (loss) per diluted share	$ 0.08	$ (0.07)	$ (0.52)	$ 0.13

Table of Contents

Goodwill and Intangibles

The Company operates in one operating segment and has one reporting unit. The following table presents the change in the carrying amount of goodwill during the year:

(in thousands)		
Balance as of January 1, 2010	$	2,391
Goodwill acquired during the period		19,222
Balance as of September 30, 2010	$	21,613

Intangible assets consist of the following:

(in thousands)		Cost		Accumulated Amortization		Net Book Value
As of September 30, 2010						
Customer related intangibles	$	44,355	$	(2,053)	$	42,302
Technology		43,446		(2,568)		40,878
Trade name		248		(103)		145
Technology designs		490		(310)		180
Non-compete agreements		100		(51)		49
Intellectual property		1,400		(1,400)		
Total	$	90,039	$	(6,485)	$	83,554
As of December 31, 2009						
Technology designs	$	490	$	(218)	$	272
Non-compete agreements		100		(36)		64
Intellectual property		1,400		(1,400)		
Total	$	1,990	$	(1,654)	$	336

Amortization expense for acquired intangibles was approximately $2.8 million during the third quarter of 2010, of which approximately $1.6 million was included in cost of software licenses and $1.2 million was included in operating expenses.

Amortization expense for acquired intangibles was $4.8 million during the first nine months of 2010, of which $2.7 million was included in cost of software licenses and $2.1 million was included in operating expenses. Amortization expense was de minimis in 2009.

(in thousands) **As of September 30,**		**Future estimated amortization expense**
Remainder of 2010	$	2,870
2011		11,315
2012		11,137
2013		11,095
2014		9,489

2015		8,688
2016 and thereafter		28,960
	$	83,554

11

Table of Contents

6. ACCRUED EXPENSES

(in thousands)	As of September 30, 2010	As of December 31, 2009
Accrued income taxes	$ 3,780	$ -
Accrued restructuring	3,245	-
Accrued professional services partner fees	2,890	1,055
Accrued other taxes	2,494	1,289
Accrued employee reimbursable expenses	2,220	