PEGASYSTEMS INC
Form 10-Q
August 09, 2011
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

x **Quarterly Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the quarterly period ended June 30, 2011

or

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

Commission File Number: 1-11859

PEGASYSTEMS INC.

(Exact name of Registrant as specified in its charter)

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

(617) 374-9600

(Registrant s telephone number including area code)

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

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

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

Large accelerated filer ¨	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 37,540,861 shares of the Registrant s common stock, $.01 par value per share, outstanding on July 28, 2011.

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PEGASYSTEMS INC.

UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands)

	As of June 30, 2011	As of December 31, 2010
ASSETS		
Current assets:		
Cash and cash equivalents	$ 66,983	$ 71,127
Marketable securities	32,634	16,124
Total cash, cash equivalents, and marketable securities	99,617	87,251
Trade accounts receivable, net of allowance of $1,357 and $1,159	96,499	79,896
Deferred income taxes	4,811	4,770
Income taxes receivable	12,969	9,266
Other current assets	6,302	7,473
Total current assets	220,198	188,656
Property and equipment, net	11,845	11,010
Long-term deferred income taxes	33,868	33,769
Long-term other assets	2,850	2,905
Intangible assets, net	74,985	80,684
Goodwill	20,451	20,451
Total assets	$ 364,197	$ 337,475
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 5,953	6,286
Accrued expenses	23,750	24,736
Accrued compensation and related expenses	25,742	27,125
Deferred revenue	76,028	56,903
Total current liabilities	131,473	115,050
Income taxes payable	6,023	5,783
Long-term deferred revenue	17,407	17,751
Other long-term liabilities	2,625	3,221
Total liabilities	157,528	141,805
Commitments and contingencies		
Stockholders equity:		
Preferred stock, 1,000 shares authorized; no shares issued and outstanding		
Common stock, 70,000 shares authorized; 37,535 shares and 37,250 shares issued and outstanding	375	372
Additional paid-in capital	127,056	122,607
Retained earnings	76,188	71,431
Accumulated other comprehensive income	3,050	1,260

Total stockholders equity		206,669		195,670
Total liabilities and stockholders equity	$	364,197	$	337,475

See notes to unaudited condensed consolidated financial statements.

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PEGASYSTEMS INC.

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share amounts)

	Three Months Ended June 30, 2011	Three Months Ended June 30, 2010	Six Months Ended June 30, 2011	Six Months Ended June 30, 2010
Revenue:				
Software license	$ 34,645	$ 28,200	$ 68,107	$ 58,543
Maintenance	28,294	20,388	55,742	35,474
Professional services	40,579	33,658	82,029	63,313
Total revenue	103,518	82,246	205,878	157,330
Cost of revenue:				
Cost of software license	1,631	1,109	3,305	1,140
Cost of maintenance	3,260	2,715	6,634	4,652
Cost of professional services	35,506	27,436	70,474	51,904
Total cost of revenue	40,397	31,260	80,413	57,696
Gross profit	63,121	50,986	125,465	99,634
Operating expenses:				
Selling and marketing	37,208	29,896	71,244	51,789
Research and development	15,696	14,010	30,829	25,636
General and administrative	6,839	6,745	13,971	11,804
Acquisition-related costs	144	3,395	482	4,903
Restructuring costs	-	6,080	141	6,080
Total operating expenses	59,887	60,126	116,667	100,212
Income (loss) from operations	3,234	(9,140)	8,798	(578)
Foreign currency transaction gain (loss)	173	(2,542)	1,189	(5,616)
Interest income, net	91	171	177	736
Other (expense) income, net	(167)	1	(139)	242
Income (loss) before provision (benefit) for income taxes	3,331	(11,510)	10,025	(5,216)
Provision (benefit) for income taxes	1,058	(3,322)	3,021	(879)
Net income (loss)	$ 2,273	$ (8,188)	$ 7,004	$ (4,337)
Net earnings (loss) per share:				
Basic	$ 0.06	$ (0.22)	$ 0.19	$ (0.12)
Diluted	$ 0.06	$ (0.22)	$ 0.18	$ (0.12)

Weighted-average number of common shares outstanding				
Basic	37,405	37,054	37,341	36,966
Diluted	38,851	37,054	38,828	36,966
Cash dividends declared per share	$ 0.03	$ 0.03	$ 0.06	$ 0.06

See notes to unaudited condensed consolidated financial statements.

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PEGASYSTEMS INC.

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

	Six Months Ended June 30, 2011		Six Months Ended June 30, 2010	
Operating activities:				
Net income (loss)	$	7,004	$	(4,337)
Adjustment to reconcile net income (loss) to cash provided by (used in) operating activities:				
Excess tax benefits from exercise or vesting of equity awards		(4,011)		(5,529)
Deferred income taxes		(83)		(321)
Depreciation and amortization		8,228		3,686
Stock-based compensation expense		4,400		3,632
Foreign currency transaction (gain) loss		377		4,011
Other		414		707
Change in operating assets and liabilities:				
Trade accounts receivable		(15,790)		(11,756)
Income taxes receivable		(3,703)		(6,651)
Other current assets		5,250		7,046
Accounts payable and accrued expenses		(2,761)		2,970
Deferred revenue		18,395		6,025
Other long-term assets and liabilities		(500)		(5,801)
Cash provided by (used in) operating activities		17,220		(6,318)
Investing activities:				
Purchase of marketable securities		(25,361)		(61,156)
Matured and called marketable securities		7,738		26,280
Sale of marketable securities		1,047		162,242
Payments for 2010 acquisition, net of cash acquired		-		(108,991)
Contingent consideration paid for an acquisition in 2008		-		(250)
Investment in property and equipment		(3,563)		(3,497)
Cash (used in) provided by investing activities		(20,139)		14,628
Financing activities:				
Issuance of common stock for share-based compensation plans		1,707		1,198
Excess tax benefits from exercise or vesting of equity awards		4,011		5,529
Dividend payments to shareholders		(2,238)		(2,216)
Common stock repurchases for tax withholdings for net settlement of equity awards		(3,569)		(4,212)
Common stock repurchases under share repurchase programs		(2,084)		(3,330)
Cash used in financing activities		(2,173)		(3,031)
Effect of exchange rate changes on cash and cash equivalents		948		(6,103)
Net decrease in cash and cash equivalents		(4,144)		(824)

Cash and cash equivalents, beginning of period		71,127		63,857
Cash and cash equivalents, end of period	$	66,983	$	63,033

See notes to unaudited condensed consolidated financial statements.

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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, 2010.

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 2011.

During the first quarter of 2011, the Company recorded adjustments to the purchase price allocation of its acquisition of Chordiant. As required by applicable business combination accounting rules, these adjustments were applied retrospectively. Therefore, other current assets, long-term other assets, goodwill, accrued expenses, and deferred tax assets have been revised as of December 31, 2010 to reflect these adjustments. These revisions did not have any impact on the Company s previously reported results of operations or cash flows. See Note 6 Acquisition, Goodwill, and Other Intangible Assets for further discussion of these adjustments.

On June 29, 2011, the Company entered into a lease arrangement for its new office headquarters in Cambridge, Massachusetts. The Company expects to cease the use of its current offices in Cambridge, Massachusetts, by the second quarter of 2012 and abandon certain leasehold improvements and furniture and fixtures. Accordingly, in June 2011 the Company revised the remaining useful lives of these fixed assets and recorded an incremental $0.2 million of depreciation expense during the second quarter of 2011 as a result of this change in estimate. The Company expects to record approximately $0.5 million of additional depreciation expense per quarter through the second quarter of 2012. See Note 10 Commitments and Contingencies for further discussion of the new lease terms.

Accounting Standards Not Yet Effective

Presentation of Comprehensive Income: In June 2011, the Financial Accounting Standards Board FASB issued Accounting Standards Update (ASU) No. 2011-05, *Comprehensive Income (Topic 220)* (ASU 2011-05), which (1) eliminates the option to present the components of other comprehensive income as part of the statement of changes in stockholders equity; (2) requires the consecutive presentation of the statement of net income and other comprehensive income; and (3) requires an entity to present reclassification adjustments on the face of the financial statements from other comprehensive income to net income. The amendments in this ASU do not change the items that must be reported in other comprehensive income or when an item of other comprehensive income must be reclassified to net income nor do the amendments affect how earnings per share is calculated or presented. This ASU is required to be applied retrospectively and is effective for fiscal years and interim periods within those years beginning after December 15, 2011, which for the Company means fiscal year 2012. The adoption of this standard will not impact the Company s financial position or results of operations as this accounting standard only requires enhanced disclosure.

Disclosure of Supplementary Pro Forma Information for Business Combinations: In December 2010, the FASB issued ASU No. 2010-29, *Disclosure of Supplementary Pro Forma Information for Business Combinations (Topic 805) Business Combinations* (ASU 2010-29), to improve consistency in how the pro forma disclosures are calculated. Additionally, ASU 2010-29 enhances the disclosure requirements and requires description of the nature and amount of any material, nonrecurring pro forma adjustments directly attributable to a business combination. ASU 2010-29 is effective for the Company in fiscal year 2012 and should be applied prospectively to business combinations for which the acquisition date is after the effective date. Early adoption is permitted. The adoption of this standard will not impact the Company s financial position or results of operations as this accounting standard only requires enhanced disclosure.

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Performing Step 2 of the Goodwill Impairment Test: In December 2010, the FASB issued ASU No. 2010-28, *When to Perform Step 2 of the Goodwill Impairment Test for Reporting Units with Zero or Negative Carrying Amounts (Topic 350) Intangibles Goodwill and Other* (ASU 2010-28). ASU 2010-28 amends the criteria for performing Step 2 of the goodwill impairment test for reporting units with zero or negative carrying amounts and requires performing Step 2 if qualitative factors indicate that it is more likely than not that a goodwill impairment exists. The Company will adopt ASU 2010-28 in fiscal year 2012 and any impairment to be recorded upon adoption will be recognized as an adjustment to its beginning retained earnings. The Company does not expect the adoption of ASU 2010-28 will have a significant impact on its consolidated financial statements.

2. MARKETABLE SECURITIES

(in thousands)	June 30, 2011			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
Marketable securities:				
Municipal bonds	$ 16,784	31	(13)	$ 16,802
Government sponsored enterprise bonds	10,003	1	(2)	10,002
Corporate bonds	4,814	17		4,831
Commercial paper	998	1		999
Marketable securities	$ 32,599	50	(15)	$ 32,634

(in thousands)	December 31, 2010			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
Marketable securities:				
Government sponsored enterprise bonds	$ 5,601	1	(9)	$ 5,593
Corporate bonds	5,468		(49)	5,419
Commercial paper	2,999		(1)	2,998
Municipal bonds	2,114			2,114
Marketable securities	$ 16,182	1	(59)	$ 16,124

All of the Company s investments are classified as available-for-sale and are carried at fair value with unrealized gains and losses recorded as a component of accumulated other comprehensive income. As of June 30, 2011, remaining maturities of marketable debt securities ranged from July 26, 2011 to November 26, 2014 with a weighted-average remaining maturity of approximately 19 months.

3. DERIVATIVE INSTRUMENTS

During the second quarter of 2011, the Company entered into forward foreign currency contracts to manage its exposure to changes in foreign currency exchange rates associated with its foreign currency denominated accounts receivable and cash. The U.S. operating company invoices most of its foreign customers in foreign currencies, which results in cash and receivables held at the end of the period to be valued in these foreign currencies. Since the U.S. operating company s functional currency is the U.S. dollar, the Company recognizes a foreign currency transaction gain or (loss) on the foreign currency denominated accounts receivable held by the U.S. operating company in its consolidated statements of operations when there are changes in the foreign currency exchange rates versus the U.S. dollar. The Company is primarily exposed to changes in the value of the Euro and British pound relative to the U.S. dollar. The forward foreign currency contracts utilized by the Company are not designated as hedging instruments and as a result, the Company records the fair value of these contracts at the end of each reporting period in its consolidated balance sheet as other current assets for unrealized gains and accrued expenses for unrealized losses, with any fluctuations in the value of these contracts recognized in other income (expense), net, in its consolidated statement of income. However, the fluctuations in the value of these forward foreign currency contracts largely offset the gains and losses from the remeasurement or settlement of the foreign currency denominated accounts receivable and cash held by the U.S. operating company, thus mitigating the volatility. Generally, the Company enters into forward foreign currency contracts with terms of 60 days or less.

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As of June 30, 2011, the Company had forward foreign currency contracts outstanding to sell 6 million British pounds and 7 million Euros and receive $19.6 million. The fair value of these outstanding forward foreign currency contracts as of June 30, 2011 totaled $0.1 million, which was recorded in accrued expenses. During the second quarter and first six months of 2011, the change in the fair value of these forward foreign currency contracts recorded in other (expense) income, net, was a loss of $0.2 million.

The net impact of the losses recorded on the forward foreign currency contracts and the foreign currency transaction gains recorded on the remeasurement and settlement of the foreign currency denominated assets was nearly zero for the second quarter of 2011.

4. FAIR VALUE MEASUREMENTS

Assets Measured at Fair Value on a Recurring Basis

The Company s assets and liabilities measured at fair value on a recurring basis are classified within the fair value hierarchy as follows:

Level 1 - Quoted prices in active markets for identical assets or liabilities.
Level 2 - Inputs other than Level 1 that are observable, either directly or indirectly, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

The Company s cash equivalents and marketable securities are classified within Level 1 or Level 2 of the fair value hierarchy because they are valued using quoted market prices, or broker dealer quotations and matrix pricing compiled by third party pricing vendors, respectively. The Company s marketable securities and forward foreign currency contracts are valued based on a market approach in which all significant inputs are observable or can be derived from or corroborated by observable market data such as interest rates, yield curves, and credit risk.

Assets and liabilities measured at fair value on a recurring basis were as follows:

		Fair Value Measurements at Reporting Date Using	
(in thousands)	**June 30, 2011**	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**
ASSETS			
Money market funds	$ 8,227	$ 8,227	$
Marketable securities:			
Municipal bonds	$ 16,802	$ 7,528	$ 9,274
Government sponsored enterprise bonds	10,002		10,002
Corporate bonds	4,831	4,831	
Commercial paper	999		999
Total marketable securities	$ 32,634	$ 12,359	$ 20,275
LIABILITIES			
Forward foreign currency contracts	$ 120	$	$ 120

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(in thousands)	December 31, 2010	Fair Value Measurements at Reporting Date Using: Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)
Money market funds	$ 14,342	$ 14,342	$
Marketable securities:			
Government sponsored enterprise bonds	$ 5,593	$ -	$ 5,593
Corporate bonds	5,419	5,419	
Commercial paper	2,998		2,998
Municipal bonds	2,114		2,114
Total marketable securities	$ 16,124	$ 5,419	$ 10,705

Assets Measured at Fair Value on a Nonrecurring Basis

Assets not recorded at fair value on a recurring basis, such as property and equipment and intangible assets, are recognized at fair value when they are impaired. During the first six months of 2011 and 2010, the Company did not recognize any nonrecurring fair value measurements from impairments. The Company recorded assets acquired and liabilities assumed related to its acquisition of Chordiant at fair value as described in Note 6 Acquisition, Goodwill, and Other Intangible Assets.

5. TRADE ACCOUNTS RECEIVABLE, NET OF ALLOWANCES

(in thousands)	June 30, 2011	December 31, 2010
Trade accounts receivable	$ 75,742	$ 65,373
Unbilled accounts receivable	22,114	15,682
Total accounts receivable	97,856	81,055
Allowance for doubtful accounts	(136)	(132)
Allowance for sales credit memos	(1,221)	(1,027)
Total allowance	(1,357)	(1,159)
	$ 96,499	$ 79,896

Unbilled trade accounts receivable relate to services earned under time and material arrangements and maintenance and license arrangements that had not been invoiced as of June 30, 2011 and December 31, 2010, respectively.

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6. ACQUISITION, GOODWILL, AND OTHER INTANGIBLE ASSETS

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 for approximately $160.3 million in cash and the issuance of stock options.

The operations of Chordiant were included in the Company s operating results from the date of acquisition. Due to the rapid integration of the products, sales force, and operations of Chordiant, it is no longer feasible for the Company to identify revenue from new arrangements attributable to Chordiant.

During the first quarter of 2011, the Company recorded adjustments to the purchase price allocation to reflect the Company s final determination of other accrued liabilities, acquired tax assets and uncertain tax liabilities. As a result of this determination, the Company recorded a $1.8 million decrease to other accrued liabilities, a $0.4 million increase to net deferred tax assets, and a corresponding $2.2 million decrease to goodwill. These purchase price adjustments were also reflected retrospectively as of December 31, 2010 in the accompanying condensed consolidated balance sheet as required by the business combination accounting rules.

Pro forma Information

The following pro forma financial information presents the combined results of operations of the Company and Chordiant as if the acquisition had occurred on January 1, 2009 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 elimination of deferred costs associated with revenue, 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. The 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, 2009.

	Pro Forma Three Months Ended June 30,	Pro Forma Six Months Ended June 30,
	2010	**2010**
Revenue	$ 85,524	$ 176,164
Net loss	(16,858)	(20,336)
Net loss per basic and diluted share	$ (0.45)	$ (0.55)

Goodwill and Intangibles

The Company operates in one operating segment, business process solutions, for which discrete financial information is available and its performance is evaluated regularly by the Company s CEO, who is the Company s chief operating decision maker, or CODM. The Company has one reporting unit, the fair value of which is evaluated annually to determine whether goodw