

Paycom Software, Inc.  
Form 10-Q  
November 07, 2014  
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, 2014**

**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: 001-36393**

**Paycom Software, Inc.**

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

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

**80-0957485**  
**(I.R.S. Employer**  
**Identification Number)**

**7501 W. Memorial Road**  
**Oklahoma City, Oklahoma 73142**  
**(Address, zip code of principal executive offices)**

**(405) 722-6900**  
**(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 (§232.405 of this chapter) 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. (Check one):

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

As of October 24, 2014, the registrant had 51,112,429 shares of common stock outstanding.

---

**Table of Contents**

**Paycom Software, Inc.**

**PART I FINANCIAL INFORMATION**

Item 1.	<u>Financial Statements (Unaudited)</u>	
	<u>Condensed Consolidated Balance Sheets as of September 30, 2014 and December 31, 2013</u>	3
	<u>Condensed Consolidated Statements of Income for the Three and Nine Months Ended September 30, 2014 and 2013</u>	4
	<u>Condensed Consolidated Statements of Cash Flows for the Nine Months Ended September 30, 2014 and 2013</u>	5
	<u>Notes to the Condensed Consolidated Financial Statements</u>	6
Item 2.	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	18
Item 3.	<u>Quantitative and Qualitative Disclosures About Market Risk</u>	29
Item 4.	<u>Controls and Procedures</u>	29

**PART II OTHER INFORMATION**

Item 1.	<u>Legal Proceedings</u>	31
Item 1A.	<u>Risk Factors</u>	31
Item 2.	<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	31
Item 3.	<u>Defaults Upon Senior Securities</u>	32
Item 4.	<u>Mine Safety Disclosures</u>	32
Item 5.	<u>Other Information</u>	32
Item 6.	<u>Exhibits</u>	32
	<u>Signatures</u>	34

**Table of Contents****PART I. FINANCIAL INFORMATION****Item 1. Financial Statements****Paycom Software, Inc.****Condensed Consolidated Balance Sheets****(in thousands, except share amounts)****(unaudited)**

	<b>September 30, 2014</b>	<b>December 31, 2013</b>
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 18,473	\$ 13,362
Restricted cash	370	369
Accounts receivable	1,468	1,705
Prepaid expenses	1,581	2,133
Inventory	384	578
Income tax receivable		150
Deferred tax assets	2,422	3,672
Current assets before funds held for clients	24,698	21,969
Funds held for clients	393,633	455,779
Total current assets	418,331	477,748
Property, plant and equipment, net of accumulated depreciation of \$15.5 million and \$11.5 million, respectively	46,642	38,671
Deposits and other assets	595	461
Goodwill	51,889	51,889
Intangible assets, net of accumulated amortization of \$11.7 million and \$10.5 million, respectively	5,499	6,709
Total assets	\$ 522,956	\$ 575,478
<b>Liabilities and Stockholders Equity</b>		
Current liabilities:		
Accounts payable	\$ 1,976	\$ 5,020
Income tax payable	148	
Accrued commissions and bonuses	2,568	3,598
Accrued payroll and vacation	2,665	3,087
Deferred revenue	2,186	1,582
Current portion of long-term debt	845	9,545
Accrued expenses and other current liabilities	3,871	4,372

Edgar Filing: Paycom Software, Inc. - Form 10-Q

Current liabilities before client funds obligation	14,259	27,204
Client funds obligation	393,633	455,779
<b>Total current liabilities</b>	<b>407,892</b>	<b>482,983</b>
Deferred tax liabilities	3,059	2,895
Long-term deferred revenue	15,048	10,990
Long-term debt, less current portion	26,341	11,545
Long-term debt to related parties		60,875
Derivative liability		1,107
<b>Total long-term liabilities</b>	<b>44,448</b>	<b>87,412</b>
Commitments and contingencies		
Stockholders' equity:		
Common stock, \$0.01 par value (100,000,000 shares authorized, 51,056,462 and 45,708,573 shares issued and outstanding at September 30, 2014 and December 31, 2013, respectively)	510	457
Additional paid in capital	66,949	33,978
Retained earnings (accumulated deficit)	3,157	(29,349)
<b>Total parent's stockholders' equity</b>	<b>70,616</b>	<b>5,086</b>
Noncontrolling interest		(3)
<b>Total stockholders' equity</b>	<b>70,616</b>	<b>5,083</b>
<b>Total liabilities and stockholders' equity</b>	<b>\$ 522,956</b>	<b>\$ 575,478</b>

See accompanying notes to the condensed consolidated financial statements.

**Table of Contents****Paycom Software, Inc.****Condensed Consolidated Statements of Income****(in thousands, except share amounts)****(unaudited)****Three Months Ended September 30, Nine Months Ended September 30,**

	<b>2014</b>	<b>2013</b>	<b>2014</b>	<b>2013</b>
<b>Revenues</b>				
Recurring	\$ 35,910	\$ 25,210	\$ 105,030	\$ 75,808
Implementation and other	688	620	1,859	1,513
Total revenues	36,598	25,830	106,889	77,321
<b>Cost of revenues</b>				
Operating expenses	5,798	4,846	17,847	13,633
Depreciation	638	494	1,876	1,320
Total cost of revenues	6,436	5,340	19,723	14,953
<b>Administrative expenses</b>				
Sales and marketing	14,856	10,339	44,237	28,913
Research and development	1,059	538	2,878	1,317
General and administrative	8,410	6,815	25,816	18,851
Depreciation and amortization	1,159	959	3,322	2,716
Total administrative expenses	25,484	18,651	76,253	51,797
Total operating expenses	31,920	23,991	95,976	66,750
Operating income	4,678	1,839	10,913	10,571
Interest expense	(338)	(2,329)	(3,079)	(6,929)
Net loss on early repayment of debt			(4,044)	
Other income (expense), net	39	(133)	1,395	140
Income (loss) before income taxes	4,379	(623)	5,185	3,782
Provision (benefit) for income taxes	1,689	(199)	2,028	1,211
Net income (loss)	2,690	(424)	3,157	2,571
Net income (loss) attributable to noncontrolling interest		(3)		19
Net income (loss) attributable to the Company	\$ 2,690	\$ (421)	\$ 3,157	\$ 2,552

Edgar Filing: Paycom Software, Inc. - Form 10-Q

Pro forma additional income tax expense (benefit)		(93)		563
Pro forma net income (loss)	\$ 2,690	\$ (328)	\$ 3,157	\$ 1,989
Net income (loss) per share, basic	\$ 0.05	\$ (0.01)	\$ 0.06	\$ 0.06
Net income (loss) per share, diluted	\$ 0.05	\$ (0.01)	\$ 0.06	\$ 0.05
Pro forma net income (loss) per share, basic	\$ 0.05	\$ (0.01)	\$ 0.06	\$ 0.04
Pro forma net income (loss) per share, diluted	\$ 0.05	\$ (0.01)	\$ 0.06	\$ 0.04
<b>Weighted average shares outstanding:</b>				
Basic	51,056,462	45,707,802	49,040,344	45,398,933
Diluted	52,978,051	45,707,802	51,223,048	47,975,548
<b>Pro forma weighted average shares outstanding:</b>				
Basic	51,056,462	45,707,802	49,040,344	45,398,933
Diluted	52,978,051	45,707,802	51,223,048	47,975,548

See accompanying notes to the condensed consolidated financial statements.

**Table of Contents****Paycom Software, Inc.****Condensed Consolidated Statements of Cash Flows****(in thousands, except share amounts)****(unaudited)**

	<b>Nine Months Ended September 30,</b>	
	<b>2014</b>	<b>2013</b>
<b>Operating activities</b>		
Net income	\$ 3,157	\$ 2,571
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	5,198	4,036
Amortization of debt discount	67	178
Write off of debt issuance costs	4,051	
Stock-based compensation	362	925
Change in fair value of derivative liability	(1,107)	257
Changes in operating assets and liabilities:		
Accounts receivable	237	(85)
Prepaid expenses	(94)	(753)
Inventory	195	(121)
Deposits and other assets	(145)	(53)
Income tax receivable	150	
Deferred tax assets	1,250	1,211
Deferred tax liabilities	164	
Income tax payable	148	
Accounts payable	(3,044)	(159)
Accrued commissions and bonuses	(1,030)	(1,195)
Accrued payroll and vacation	(422)	(170)
Deferred revenue	4,662	2,775
Accrued expenses and other liabilities	(498)	2,679
Net cash provided by operating activities	13,301	12,096
<b>Investing activities</b>		
Decrease in funds held for clients	62,146	82,294
Increase (decrease) in restricted cash	1	(1)
Additions to property, plant and equipment	(11,948)	(6,243)
Net cash provided by investing activities	50,199	76,050
<b>Financing activities</b>		
Proceeds from issuance of long-term debt	6,539	
Proceeds from initial public offering	62,842	
Payments on long-term debt	(65,442)	1,750



Edgar Filing: Paycom Software, Inc. - Form 10-Q

Decrease in client funds obligation	(62,146)	(82,294)
Incentive awards redeemed		(1,061)
Capital impact of reorganization	(183)	
Capital contribution	1	1,162
Net cash used in financing activities	(58,389)	(80,443)
Change in cash and cash equivalents	5,111	7,703
<b>Cash and cash equivalents</b>		
Beginning of period	13,362	13,435
End of period	\$ 18,473	\$ 21,138

See accompanying notes to the condensed consolidated financial statements.

---

**Table of Contents**

**Paycom Software, Inc.**

**Notes to the Condensed Consolidated Financial Statements**

**(in thousands, except share and per share amounts)**

**(unaudited)**

**1. CONSOLIDATION AND BASIS OF PRESENTATION**

***The Reorganization***

Paycom Software, Inc. ( Software ) and its wholly-owned subsidiary, Payroll Software Merger Sub, LLC ( Merger Sub ) were formed as Delaware entities on October 31, 2013, and December 23, 2013, respectively, in anticipation of an initial public offering ( IPO ) and were wholly-owned subsidiaries of Paycom Payroll, LLC ( Paycom ) prior to December 31, 2013.

On January 1, 2014, we consummated a reorganization pursuant to which: (i) affiliates of Welsh, Carson, Anderson & Stowe, L.P. contributed WCAS Paycom Holdings, Inc. ( WCAS Holdings ) and WCAS CP IV Blocker, Inc. ( CP IV Blocker ), which collectively own all of the Series A Preferred Units of Paycom Payroll Holdings, LLC ( Holdings ), to Software in exchange for shares of common stock of Software and (ii) the owners of outstanding Series B Preferred Units of Holdings contributed their Series B Preferred Units of Holdings to Software in exchange for shares of common stock of Software. Immediately after these contributions, Merger Sub merged with and into Holdings with Holdings surviving the merger. Upon consummation of the merger, the remaining holders of outstanding common and incentive units of Holdings received shares of common stock of Software for their common and incentive units by operation of Delaware law and Holdings' ownership interest in Software was cancelled. Outstanding common units, Series B Preferred Units and WCAS Holdings and CP IV Blocker were contributed to Software in exchange for, or converted into, 45,708,573 shares of common stock and 8,121,101 shares of restricted stock of Software. Following these transactions, all outstanding Series C Preferred Units were eliminated in an intercompany transaction between Holdings and WCAS Holdings, and we assumed the 14% Note due 2017 issued by WCAS Holdings (the 2017 Note ). Following the reorganization, Software became a holding company with its principal asset being the Series A Preferred Units of Holdings (collectively, the 2014 Reorganization ).

Software's acquisition of WCAS Holdings and Holdings in the 2014 Reorganization represented transactions under common control and were required to be retrospectively applied to the financial statements for all prior periods when the financial statements were issued for a period that included the date the transactions occurred. Therefore, our consolidated financial statements are presented as if WCAS Holdings and Holdings were wholly-owned subsidiaries in periods prior to the 2014 Reorganization. The acquisition of CP IV Blocker was not deemed to be a reorganization under common control and therefore our historical consolidated financial statements for periods prior to January 1, 2014 include the ownership of a minority equity interest in CP IV Blocker, which was eliminated upon the acquisition of CP IV Blocker on January 1, 2014.

Our unaudited interim condensed consolidated financial statements include the financial results of Software, WCAS Holdings, CP IV Blocker and Holdings, effective January 1, 2014. Intercompany balances and transactions were eliminated in consolidation.

Unless we state otherwise or the context otherwise requires, the terms we, us, our and the Company refer, prior to the 2014 Reorganization, to Holdings, Holdings' consolidated subsidiaries and WCAS Holdings collectively, and after the

2014 Reorganization, to Software and its consolidated subsidiaries.

***Basis of Presentation***

The accompanying unaudited interim condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles in the United States of America ( U.S. GAAP ) and applicable rules and regulations of the Securities and Exchange Commission ( SEC ) regarding interim financial statements that permit reduced disclosure for interim periods. In the opinion of management, the accompanying unaudited condensed consolidated financial statements include all adjustments necessary to fairly present our condensed consolidated financial position as of September 30, 2014 and December 31, 2013, our condensed consolidated results of operations for the three and nine months ended September 30, 2014 and 2013 and our condensed consolidated cash flows for the nine months ended September 30, 2014 and 2013. Such adjustments are of a normal recurring nature. The information in this Quarterly Report on Form 10-Q should be read in conjunction with our final prospectus filed pursuant to Rule 424(b) (the Prospectus ) with the SEC on April 15, 2014.

***Use of Estimates***

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes.

**Table of Contents**

Paycom Software, Inc.

Notes to the Condensed Consolidated Financial Statements

(in thousands, except share and per share amounts)

(unaudited)

Significant estimates include the useful life for long-lived and intangible assets, the life of our client relationships, the fair market value of our equity incentive awards and the fair value of our financial instruments. These estimates are based on historical experience where applicable and other assumptions that management believes are reasonable under the circumstances. As such, actual results could materially differ from these estimates.

***Segment Information***

We operate in a single operating segment and a single reporting segment and all required financial segment information is presented in the condensed consolidated financial statements.

***Anti-Dilutive Securities***

We excluded 2,301,603 shares of restricted stock from the diluted earnings per share calculation for the three months ended September 30, 2013 because the shares were anti-dilutive.

***Subsequent Events***

We have evaluated subsequent events for recognition or disclosure in our condensed consolidated financial statements and determined that no subsequent events would require adjustment to the condensed consolidated financial statements or additional disclosure other than the information disclosed herein. See Note 13-Subsequent Events.

***Summary of Significant Accounting Policies***

Software's significant accounting policies are discussed in Note 2 to its audited consolidated financial statements for the fiscal year December 31, 2013 included in the Prospectus filed with the SEC on April 15, 2014, and have not changed.

***Recently Issued and Adopted Accounting Pronouncements***

In July 2013, the Financial Accounting Standards Board ( FASB ) issued authoritative guidance which requires entities to present an unrecognized tax benefit, or a portion of an unrecognized tax benefit, in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward. We adopted this new guidance during the nine months ended September 30, 2014, which did not have a material impact on our condensed consolidated financial statements.

In May 2014, the FASB issued authoritative guidance which included a comprehensive new revenue recognition model that requires revenue to be recognized in a manner to depict the transfer of goods or services to a customer at an amount that reflects the consideration expected to be received in exchange for those goods or services. The new

guidance is effective for fiscal years, and interim periods within those years, beginning after December 15, 2016, and early adoption is not permitted. Accordingly, the standard is effective for us on January 1, 2017. We are currently evaluating the impact that the standard will have on our condensed consolidated financial statements.

In June 2014, the FASB issued authoritative guidance for share-based payments which requires that a performance target that affects vesting, and that could be achieved after the requisite service period, be treated as a performance condition. As such, the performance target should not be reflected in estimating the grant date fair value of the award. This update further clarifies that compensation cost should be recognized in the period in which it becomes probable that the performance target will be achieved and should represent the compensation cost attributable to the period(s) for which the requisite service has already been rendered. The new guidance is effective for fiscal years, and interim periods within those years, beginning after December 15, 2015. Accordingly, the standard is effective for us on January 1, 2016. We do not anticipate that the adoption of this standard will have a material impact on our condensed consolidated financial statements.

**Table of Contents**

## Paycom Software, Inc.

## Notes to the Condensed Consolidated Financial Statements

(in thousands, except share and per share amounts)

(unaudited)

**2. PROPERTY, PLANT AND EQUIPMENT**

Property, plant and equipment and accumulated depreciation were as follows:

	<b>September 30, 2014</b>	<b>December 31, 2013</b>
Property, plant and equipment		
Buildings	\$ 28,154	\$ 14,828
Software and capitalized software costs	7,635	5,578
Computer equipment	6,613	4,832
Rental clocks	6,111	4,865
Furniture, fixtures and equipment	4,073	3,189
Vehicles	421	421
Leasehold improvements	159	135
	53,166	33,848
Less: accumulated depreciation	(15,517)	(11,540)
	37,649	22,308
Land	8,993	8,993
Construction in process		7,370
Property, plant and equipment, net	\$ 46,642	\$ 38,671

Rental clocks included in property, plant and equipment, net represent time clocks issued to clients under month-to-month operating leases. These items are transferred upon issuance from inventory to fixed assets and depreciated over their estimated useful lives.

Depreciation expense for property, plant and equipment, net was \$1.4 million and \$4.0 million for the three and nine months ended September 30, 2014, respectively. Depreciation expense for property, plant and equipment, net was \$1.0 million and \$2.8 million for the three and nine months ended September 30, 2013, respectively.

We capitalize interest incurred under our indebtedness related to construction of our principal executive offices. For the three months ended September 30, 2014, we paid interest costs of \$0.3 million, none of which was capitalized. For the nine months ended September 30, 2014, we paid interest costs of \$0.9 million, of which \$0.4 million was capitalized. For the three and nine months ended September 30, 2013, we paid interest costs of \$0.2 million and \$0.6

million, respectively, of which less than \$0.1 million was capitalized for each respective time period.

### **3. GOODWILL AND INTANGIBLE ASSETS, NET**

We had goodwill of \$51.9 million as of September 30, 2014 and December 31, 2013. We have selected June 30 as our annual goodwill impairment testing date and determined there was no impairment as of June 30, 2014. For the year ended December 31, 2013, there were no indicators of impairment.

**Table of Contents**

## Paycom Software, Inc.

## Notes to the Condensed Consolidated Financial Statements

(in thousands, except share and per share amounts)

(unaudited)

All of our intangible assets are considered to have finite lives and, as such, are subject to amortization. The components of intangible assets were as follows:

	<b>September 30, 2014</b>			
	<b>Weighted Avg. Remaining Useful Life (Years)</b>	<b>Gross</b>	<b>Accumulated Amortization</b>	<b>Net</b>
<b>Intangibles:</b>				
Customer relationships	2.8	\$ 13,997	\$ (10,147)	\$ 3,850
Trade name	7.8	3,194	(1,545)	1,649
Total		\$ 17,191	\$ (11,692)	\$ 5,499

	<b>December 31, 2013</b>			
	<b>Weighted Avg. Remaining Useful Life (Years)</b>	<b>Gross</b>	<b>Accumulated Amortization</b>	<b>Net</b>
<b>Intangibles:</b>				
Customer relationships	3.5	\$ 13,997	\$ (9,098)	\$ 4,899
Trade name	8.5	3,194	(1,384)	1,810
Total		\$ 17,191	\$ (10,482)	\$ 6,709

The weighted average remaining useful life of our intangible assets was 4.3 years as of September 30, 2014. Amortization of intangible assets for the three and nine months ended September 30, 2014 was \$0.4 million and \$1.2 million, respectively. Amortization of intangible assets for the three and nine months ended September 30, 2013 was \$0.4 million and \$1.2 million, respectively. Estimated amortization expense as of September 30, 2014 for our existing intangible assets for the next five years and thereafter was as follows:



<b>Year Ending</b>	<b>Amortization Expense</b>
<b>December 31,</b>	
2014	\$ 403
2015	1,613
2016	1,613
2017	913
2018	213
Thereafter	744
	\$ 5,499

#### **4. FUNDS HELD FOR CLIENTS AND CLIENT FUNDS OBLIGATION**

As part of our payroll and tax filing application, we collect funds for federal, state and local employment taxes from clients, handle applicable regulatory tax filings, correspondence and amendments, remit the funds to appropriate tax agencies, and handle other employer-related services. Amounts collected by us from clients for their federal, state and local employment taxes earn interest during the interval between receipt and disbursement, as we invest these funds in money market funds and certificates of deposit. These collections from clients are typically disbursed from one to 30 days after receipt, with some funds being held for up to 120 days. These investments are shown in the Condensed Consolidated Balance Sheets as Funds held for clients, and the offsetting liability for the tax filings is shown as Client funds obligation. As of September 30, 2014 and December 31, 2013, the funds held for clients were invested in demand deposits, short-term certificates of deposit and money market funds. The interest earned on these funds is included in Other income (expense), net, on the Condensed Consolidated Statements of Income.

**Table of Contents**

## Paycom Software, Inc.

## Notes to the Condensed Consolidated Financial Statements

(in thousands, except share and per share amounts)

(unaudited)

**5. LONG-TERM DEBT**

Our long-term debt consisted of the following:

	<b>September 30, 2014</b>	<b>December 31, 2013</b>
Term note to bank due December 15, 2018 <sup>(1)</sup>	\$	\$ 11,963
Construction note to bank <sup>(2)</sup>		9,127
Term note to bank due June 1, 2021 <sup>(3)</sup>	27,186	
Note to related party due April 3, 2017 <sup>(4)</sup>		46,193
Note to related party due April 3, 2022 <sup>(5)</sup>		18,807
Less: Unamortized debt discounts		(4,125)
<b>Total long-term debt (including current portion)</b>	<b>27,186</b>	<b>81,965</b>
Less: Current portion	(845)	(9,545)
<b>Total long-term debt, net</b>	<b>\$ 26,341</b>	<b>\$ 72,420</b>

(1) In March 2013, we entered into a construction loan agreement for the construction of a second building at our corporate headquarters with Kirkpatrick Bank due May 1, 2015, which allowed for a maximum principal amount of \$12.3 million (the 2013 Construction Loan ). The 2013 Construction Loan was secured by a first mortgage covering the second headquarters building and a first lien security interest in certain personal property relating to the second headquarters building. Under the 2013 Construction Loan, interest accrued monthly at the Wall Street Journal U.S. Prime Rate plus 0.5%, adjusted monthly, subject to a minimum interest rate of 4.0% per annum. Interest on the 2013 Construction Loan was payable monthly on the first day of each month. The 2013 Construction Loan, along with the 2011 Consolidated Loan, was converted into a term loan in July 2013 (the 2013 Term Loan ).

In November 2013, we entered into a loan agreement for the purchase of approximately 18.3 acres for future expansion at our headquarters with Kirkpatrick Bank, which allowed for a maximum principal amount of \$3.0 million ( 2013 Land Loan ). Under the 2013 Land Loan, interest accrued monthly at the Wall Street Journal U.S. Prime Rate plus 0.5%, adjusted monthly, subject to a minimum interest rate of 4.0% per annum.

In December 2013, we consolidated the 2013 Term Loan and the 2013 Land Loan ( 2013 Consolidated Loan ) under a modification agreement that increased the combined maximum principal amount of the 2013 Consolidated Loan to

\$14.6 million. The 2013 Consolidated Loan was secured by a first mortgage covering all of the second headquarters building and a first lien security interest in certain personal property relating to the second headquarters building. Under the 2013 Consolidated Loan, interest accrued monthly at the Wall Street Journal U.S. Prime rate plus 0.5%, adjusted monthly, subject to a minimum interest rate of 4.0% per annum. In the second quarter of 2014, the 2013 Consolidated Loan was consolidated into the 2021 Consolidated Loan.

The 2011 Consolidated Loan and the 2013 Consolidated Loan were subject to certain financial covenants, as defined in the applicable agreement, including maintaining a debt coverage ratio of EBITDA to indebtedness (defined as current maturities of long-term debt, interest expense and distributions) of greater than 1.5 to 1.0. As of December 31, 2013, we were not in compliance with the financial covenant related to the debt coverage ratio. We obtained a letter of waiver from the lender that excluded certain items from the calculation as of December 31, 2013 and which remains in effect through April 30, 2015.

**Table of Contents**

Paycom Software, Inc.

Notes to the Condensed Consolidated Financial Statements

(in thousands, except share and per share amounts)

(unaudited)

- (2) In December 2011, we consolidated pre-existing construction loans for the construction of a new corporate headquarters, processing center and gymnasium into a term note (the 2011 Consolidated Loan ). Under the 2011 Consolidated Loan, principal and interest were payable monthly based on a 20 year amortization rate of 5.0%. The 2011 Consolidated Loan was collateralized by a first mortgage covering our original corporate headquarters building and was secured by a first lien security interest in certain personal property relating to our original corporate headquarters building. In the second quarter of 2014, the 2011 Consolidated Loan was consolidated into the 2021 Consolidated Loan. See Note (3) below for the definition of, and more information about, the 2021 Consolidated Loan.
- (3) At September 30, 2014, our outstanding indebtedness consisted of a term note under a Loan Agreement (the 2021 Consolidated Loan ) with an outstanding principal balance of \$27.2 million as of September 30, 2014. In June 2014, we consolidated outstanding amounts under the 2011 Consolidated Loan and 2013 Consolidated Loan into the 2021 Consolidated Loan under a modification agreement. The 2021 Consolidated Loan is due to Kirkpatrick Bank and matures on May 30, 2021. Under the 2021 Consolidated Loan, interest is payable monthly and accrues at a fixed rate of 4.75% per annum. The 2021 Consolidated Loan is secured by a mortgage covering our headquarters buildings and certain personal property relating to our headquarters buildings. The 2021 Consolidated Loan includes certain financial covenants, including maintaining a debt coverage ratio of EBITDA to indebtedness (defined as current maturities of long-term debt, interest expense and distributions), as defined in the applicable agreement, of greater than 1.5 to 1.0. We were in compliance with the financial covenant related to the debt coverage ratio as of September 30, 2014.
- (4) In April 2014, we paid off the balance of the 2017 Note that was issued by WCAS Holdings and was payable to Welsh, Carson, Anderson & Stowe X, L.P., a related party ( WCAS X ) with proceeds from our IPO. The 2017 Note accrued interest at a rate of 14% per annum. As of December 31, 2013, the outstanding principal balance of the 2017 Note was \$46.2 million.
- (5) In April 2014, we paid off the balance of the 10% Senior Note due 2022 (the 2022 Note ) with WCAS Capital Partners IV, L.P., a related party ( WCAS CP IV ) with proceeds from our IPO and from existing cash. The 2022 Note accrued interest at a rate of 10% per annum. As of December 31, 2013, the outstanding principal amount of the 2022 Note was \$18.8 million. The 2022 Note was issued at a discount of \$2.4 million. The total unamortized discount related to this note was \$4.1 million. As of December 31, 2013, in conjunction with the payoff of this note, we wrote off the remaining unamortized discount of \$0.5 million. As of September 30, 2014, the carrying value and fair value of our total long-term debt, including the current portion, were each \$27.2 million. As of December 31, 2013, the carrying value and fair value of our total long-term debt,

including the current portion, were \$82.0 million and \$84.9 million, respectively. The fair value of variable rate long-term debt approximates its market value because the cost of borrowing fluctuates based upon market conditions. The fair value of fixed rate long-term debt is estimated based on the borrowing rates currently available to us for bank loans with similar terms and maturities.

## **6. EMPLOYEE SAVINGS PLAN**

Our employees that are over the age of 21 and have completed 90 days of service are eligible to participate in our 401(k) plan. We have made a Qualified Automatic Contribution Arrangement ( QACA ) election, whereby we make a matching contribution equal to 100% of the first 1% of salary deferrals and 50% of salary deferrals between 2% and 6%, up to a maximum matching contribution of 3.5% of salary each plan year for our employees. We are allowed to make additional discretionary matching contributions and discretionary profit sharing contributions. Employees are 100% vested in amounts attributable to salary deferrals and rollover contributions. The QACA matching contributions will be 100% vested after two years of employment from the date of hire. If an employee terminates service prior to completing two years of employment, the employee will not be vested in these contributions. The discretionary contributions are vested over a six year period. Matching contributions amounted to \$0.4 million and \$1.3 million for the three and nine months ended September 30, 2014, respectively. Matching contributions amounted to \$0.3 million and \$0.9 million for the three and nine months ended September 30, 2013, respectively.

**Table of Contents**

Paycom Software, Inc.

Notes to the Condensed Consolidated Financial Statements

(in thousands, except share and per share amounts)

(unaudited)

**7. FAIR VALUE OF FINANCIAL INSTRUMENTS**

Our financial instruments consist primarily of cash and cash equivalents, accounts receivable, accounts payable, funds held for clients, client funds obligation, long-term debt and derivative liability. The carrying amount of cash and cash equivalents, accounts receivable, accounts payable, funds held for clients and client fund obligations approximates fair value because of the short-term nature of the instruments.

We measure certain financial assets and liabilities at fair value at each reporting period. Fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or liability. A financial instrument's classification within the fair value hierarchy is based upon the lowest level of input that is significant to the fair value measurement. Three levels of inputs may be used to measure fair value are as follow:

Level 1 Unadjusted observable inputs that reflect quoted prices in active markets

Level 2 Input other than quoted prices in active markets that are directly or indirectly observable

Level 3 Unobservable inputs that are supported by little or no market activity

We use observable data, when available. During the three and nine months ended September 30, 2014 and 2013, we did not have any transfers between Levels 1, 2 or 3 in the three-tier fair value hierarchy.

We had no financial assets or liabilities measured at fair value on a recurring basis as of September 30, 2014. The following tables provide a summary of the fair value of financial instruments that are measured on a recurring basis using the above input categories as of December 31, 2013:

	December 31, 2013			Total
	Level 1	Level 2	Level 3	
<i>Liabilities</i>				
Derivative liability	\$	\$	\$ 1,107	\$ 1,107
	\$	\$	\$ 1,107	\$ 1,107

The derivative liability related to the 2022 Note was classified as a Level 3 financial instrument due to valuation being based upon significant unobservable inputs.

Edgar Filing: Paycom Software, Inc. - Form 10-Q

The key inputs used to calculate the fair value of the embedded derivative are: probability of exit, remaining term, yield volatility, credit spread, and risk-free rate. In general, increases in the probability of exit, credit spread, and risk-free rate would increase the value of the embedded derivative. Conversely, increases in the remaining term and yield volatility would decrease the value of the embedded derivative.

Quantitative information regarding significant unobservable inputs used for recurring Level 3 fair value measurements of financial instruments were as follows as of December 31, 2013:

	Valuation Technique	December 31, 2013	
		Key Inputs	Range
Derivative Liability	Lattice Model	Probability of exit	90%
		Remaining term	0.8 years - 8.3 years
		Yield Volatility	21.4% - 31.1%
		Credit Spread	8.90%
		Risk-free rate	0.13% - 2.45%

**Table of Contents**

## Paycom Software, Inc.

## Notes to the Condensed Consolidated Financial Statements

(in thousands, except share and per share amounts)

(unaudited)

The following table summarizes the changes in fair value of our Level 3 financial instruments for the three and nine months ended September 30, 2014 and 2013:

	<b>Three Months</b>	<b>Nine Months</b>
	<b>Ended September 30, 2014</b>	<b>Ended September 30, 2014</b>
Beginning Balance	\$	\$ 1,107
Issuances		
Change in fair value of derivative liability		(635)
Write-off to Other income (expense)		(472)
Ending Balance	\$	\$

	<b>Three Months</b>	<b>Nine Months</b>
	<b>Ended September 30, 2013</b>	<b>Ended September 30, 2013</b>
Beginning Balance	\$ 1,766	\$ 1,767
Issuances		
Change in fair value of derivative liability	(659)	(660)
Ending Balance	\$ 1,107	\$ 1,107

Total change in fair value of derivative liability recognized as Other income (expense), net in the Condensed Consolidated Statements of Income was \$(0.7 million) for each of the three and nine months ended September 30, 2013. Total change in fair value of derivative liability, including write-off of the balance due to payoff of the associated loan, recognized as Other income (expense), net in the Condensed Consolidated Statements of Income, was \$0 and \$(1.1 million) for the three and nine months ended September 30, 2014, respectively.

**8. EARNINGS PER SHARE**

Basic earnings per share (EPS) is based on the weighted average number of shares of common stock outstanding for the period. Diluted EPS is computed in a similar manner to basic EPS after assuming the issuance of shares of common stock for all potentially dilutive shares of restricted stock whether or not they are vested.



Edgar Filing: Paycom Software, Inc. - Form 10-Q

Under the 2014 Reorganization, all the outstanding common units, Series B Preferred Units and incentive units of Holdings were exchanged for, or converted into, 45,708,573 shares of our common stock and 8,121,101 shares of our restricted stock as of January 1, 2014.

The following is a reconciliation of net income (loss) and the shares of common stock used in the computation of basic and diluted net earnings per share:

	Three Months Ended		Nine Months Ended	
	September 30, 2014	September 30, 2013	September 30, 2014	September 30, 2013
<b>Numerator:</b>				
Net income (loss)	\$ 2,690	\$ (424)	\$ 3,157	\$ 2,571
Net income (loss) attributable to non-controlling interest		(3)		19
Net income (loss) attributable to the Company	\$ 2,690	\$ (421)	\$ 3,157	\$ 2,552
<b>Denominator:</b>				
Weighted average shares outstanding	51,056,462	44,560,053	49,040,344	44,560,053
Adjustment for vested restricted stock		1,147,749		838,880
Shares for calculating basic EPS	51,056,462	45,707,802	49,040,344	45,398,933
Weighted average shares outstanding	51,056,462	45,707,802	49,040,344	44,560,053
Dilutive effect of unvested restricted stock	1,921,589		2,182,704	3,415,495
Shares for calculating diluted EPS	52,978,051	45,707,802	51,223,048	47,975,548
<b>Net income (loss) per share:</b>				
Basic	\$ 0.05	\$ (0.01)	\$ 0.06	\$ 0.06
Diluted	\$ 0.05	\$ (0.01)	\$ 0.06	\$ 0.05

We excluded 2,301,603 shares of restricted stock from the diluted earnings per share calculation for the three months ended September 30, 2013 because the shares were anti-dilutive.

**Table of Contents**

## Paycom Software, Inc.

## Notes to the Condensed Consolidated Financial Statements

(in thousands, except share and per share amounts)

(unaudited)

There is no difference in net income and pro forma net income for either the three or nine months ended September 30, 2014. The following is a reconciliation of pro forma net income for the three and nine months ended September 30, 2013 and the shares of stock used in the computation of pro forma basic and diluted net income per share:

	Three Months Ended September 30, 2013	Nine Months Ended September 30, 2013
<b>Pro forma numerator:</b>		
Net income (loss) attributable to the Company	\$ (421)	\$ 2,552
Pro forma additional income tax expense (benefit) (Note 12)	(93)	563
Pro forma net income (loss) attributable to the Company (Note 12)	\$ (328)	\$ 1,989
<b>Pro forma denominator:</b>		
Pro forma weighted average shares outstanding	44,560,053	44,560,053
Adjustment for vested restricted stock	1,147,749	838,880
Pro forma shares for calculating basic EPS	45,707,802	45,398,933
Pro forma weighted average shares outstanding	45,707,802	44,560,053
Effect of dilutive restricted stock		3,415,495
Pro forma shares for calculating diluted EPS	45,707,802	47,975,548
<b>Pro forma net income per share:</b>		
Basic	\$ (0.01)	\$ 0.04

Diluted	\$	(0.01)	\$	0.04
---------	----	--------	----	------

See Note 12 Income Taxes for additional information regarding pro forma income tax expense.

## 9. STOCKHOLDERS EQUITY AND INCENTIVE COMPENSATION

Prior to the 2014 Reorganization, Holdings had four authorized classes of limited liability company interests (each a unit). Series A Preferred Units were voting units with first priority of distribution, entitled to a preferred yield (as defined within our limited liability company agreement) of 9% with regard to certain future asset distributions and conversion features. Series B Preferred Units were non-voting units, entitled to receive distributions only after certain conditions were met. Common units were voting units. Incentive units were non-voting units reserved for issuance to our employees, officers, directors and other service providers.

On January 1, 2014, we consummated the 2014 Reorganization, pursuant to which: (i) affiliates of Welsh, Carson, Anderson & Stowe, L.P., contributed WCAS Holdings and CP IV Blocker, which collectively own all of the Series A Preferred Units of Holdings, to Software in exchange for shares of common stock of Software and (ii) the owners of outstanding Series B Preferred Units of Holdings contributed their Series B Preferred Units of Holdings to Software in exchange for shares of common stock of Software. Immediately after these contributions, Merger Sub merged with and into Holdings with Holdings surviving the merger. Upon consummation of the merger, the remaining holders of outstanding common and incentive units of Holdings received shares of common stock of Software for their common and incentive units by operation of Delaware law and Holdings' ownership interest in Software was cancelled. Outstanding common units, Series B Preferred Units and WCAS Holdings and CP IV Blocker were contributed to Software in exchange for, or converted into, 45,708,573 shares of common stock and 8,121,101 shares of restricted common stock of Software.

The shares of restricted stock were issued subject to various vesting conditions. A portion of the restricted stock is subject to time-based vesting conditions, while the remaining portion is subject to performance-based vesting conditions. The performance-based vesting conditions are based on our total enterprise value exceeding certain specified thresholds. For additional information concerning the vesting conditions of the restricted stock, see Executive Compensation Narrative Discussion Regarding Summary Compensation Table Equity Incentive Units and Restricted Stock Awards included in the Prospectus filed with the SEC on April 15, 2014.

Following these transactions, all outstanding Series C Preferred Units were eliminated in an intercompany transaction between Holdings and WCAS Holdings, and we assumed the 2017 Note. As a result of the 2014 Reorganization, we recorded a one-time reclassification of \$29.6 million of historical accumulated deficit to additional paid in capital on January 1, 2014. Following the 2014 Reorganization, Software became a holding company with its principal asset being the Series A Preferred Units of Holdings.

**Table of Contents**

Paycom Software, Inc.

Notes to the Condensed Consolidated Financial Statements

(in thousands, except share and per share amounts)

(unaudited)

As of September 30, 2014 and December 31, 2013, there was \$1.0 million and \$1.3 million, respectively, of total unrecognized compensation cost related to unvested restricted stock issued to employees. The unrecognized compensation cost is expected to be recognized over a weighted average period of 2.9 years. On April 21, 2014, 217,378 shares of restricted stock automatically vested and converted into shares of common stock.

**10. RELATED-PARTY TRANSACTIONS**

During the three months ended September 30, 2014 and 2013, we paid Advantage Benefits Plus ( Advantage ) a total of \$31 thousand and \$3 thousand, respectively, for administering our employee cafeteria plan. During the nine months ended September 30, 2014 and 2013, we paid Advantage a total of \$39 thousand and \$8 thousand, respectively, for administering our employee cafeteria plan. Employee payroll deductions are sent to Advantage and we are billed monthly for an administrative fee. Advantage is owned by the spouse of Craig E. Boelte, our Chief Financial Officer.

Our Dallas office building is owned by 417 Oakbend, LP, a Texas limited partnership. Jeff York, our Chief Sales Officer, owns a .01% general partnership interest and a 10.49% limited partnership interest in 417 Oakbend, LP. During each of the three months ended September 30, 2014 and 2013, we paid rent on our Dallas office space in the amounts of less than \$0.1 million. During each of the nine months ended September 30, 2014 and 2013, we paid rent on our Dallas office space in the amounts of \$0.2 million.

In connection with the corporate reorganization in April 2012, we entered into the 2022 Note with WCAS CP IV, a related party. We paid off the balance of this note in April 2014 with proceeds from our IPO and with existing cash on hand.

In connection with the 2014 Reorganization, we assumed the 2017 Note that was issued by WCAS Holdings and was payable to WCAS X. We paid off the balance of this note in April 2014 with proceeds from our IPO.

We entered into a Limited Liability Company Unit Redemption Agreement, effective as of January 26, 2013, pursuant to which we purchased 2,605 incentive units from a former employee at a purchase price of \$260.21 per unit, which price was based on a third party appraisal and an internal appraisal. The incentive units were purchased from the former employee for an aggregate purchase price of approximately \$0.7 million. The former employee is the brother of William X. Kerber III, our Chief Information Officer.

**11. COMMITMENTS AND CONTINGENCIES**

**Funding Agreement**

In March 2010, we entered into a funding agreement with the Oklahoma City Economic Development Trust (the Trust ) and the city of Oklahoma City. The Trust provided \$2.0 million as an up-front job creation payment for the

construction of certain public infrastructure improvements related to our new principal executive offices in northwest Oklahoma City. In exchange for the funding, we agreed to create at least 492 jobs over a five year period, with an average first year salary in excess of \$37 thousand and make a minimum capital investment in the project of at least \$15.0 million. We further agreed that we would be responsible for repayment of any amount that was not offset by earned job creation payments. As of September 30, 2014 and December 31, 2013, we had earned \$1.9 million and \$1.5 million of job creation payments, respectively. We believe that we will fulfill the obligations under this agreement within the time frame specified.

### **Legal Proceedings**

In July 2013, Dr. Lakshmi Arunachalam filed a complaint against Paycom Payroll, LLC ( Paycom ) in the U.S. District Court for the District of Delaware alleging that Paycom infringes on U.S. Patent No. 8,244,833 assigned to her. Paycom denied all claims made against it by Dr. Arunachalam in her complaint, asserted various defenses and counterclaims for non-infringement and challenged the validity and enforceability of U.S. Patent No. 8,244,833. The initial lawsuit was dismissed and a complaint was filed by Pi-Net International, Inc. on April 18, 2014, along with the claims of infringement of two additional patents, U.S. Patent No. 5,987,500 and U.S. Patent No. 8,108,492. On July 1, 2014, Paycom, Webexchange, Inc., Dr. Arunachalam, and Pi-Net International, Inc. entered into a confidential settlement agreement. As part of this settlement agreement, Pi-Net International, Inc. and Paycom entered a stipulation of dismissal with prejudice on July 1, 2014.

**Table of Contents**

## Paycom Software, Inc.

## Notes to the Condensed Consolidated Financial Statements

(in thousands, except share and per share amounts)

(unaudited)

On September 23, 2014, we filed a complaint against National Financial Partners Corp. in the United States District Court for the Western District of Oklahoma (Civil Action No. 5:14-cv-01029-R) seeking a declaratory judgment that we have not engaged in any trademark infringement or unfair competition in connection with the use of our logo. On September 23, 2014, National Financial Partners Corp. filed a complaint against Software in the United States District Court for the Northern District of Illinois (Civil Action No. 1:14-cv-07424). The complaint alleges trademark infringement, unfair competition, deceptive trade practices, consumer fraud and deceptive business practices related to the adoption and use of our logo and seeks an injunction prohibiting us from continued infringement as well as money damages, including an accounting for sales and profits, attorneys' fees and disgorgement of profits. On October 20, 2014, we filed a motion to transfer the action from the Northern District of Illinois to the Western District of Oklahoma, and a memorandum in support of the motion to transfer, in the Northern District of Illinois. We intend to vigorously defend this litigation. In the event that a court ultimately determines that we have infringed any of the asserted trademarks, we may be subject to damages, which may include treble damages, and/or an injunction that could cause us to modify our logo and/or undergo a rebranding of our solution and applications. We cannot predict with any degree of certainty the outcome of the litigation or determine the extent of any potential liability or damages.

We are involved in various other legal proceedings in the ordinary course of business. Although we cannot predict the outcome of these proceedings, legal matters are subject to inherent uncertainties and there exists the possibility that the ultimate resolution of these matters could have a material adverse effect on our business, financial condition, results of operations or cash flows.

**Operating Leases**

We lease office space under several noncancellable operating leases with contractual terms expiring from 2014 to 2019. Minimum rent expense is recognized over the lease term. The lease term is defined as the fixed noncancellable term of the lease plus all periods, if any, for which failure to renew the lease imposes a penalty on us in an amount that a renewal appears, at the inception of the lease, to be reasonably assured. When a lease contains a predetermined fixed escalation of the minimum rent, we recognize the related rent expense on a straight-line basis and record the difference between the recognized rent expense and the amount payable under the lease as a liability.

Future annual minimum lease payments under noncancellable operating leases with initial or remaining terms of one year or more at September 30, 2014 were as follows:

<b>Year Ending December 31,</b>	<b>Operating</b>
2014	\$ 927
2015	3,811
2016	3,542

2017	3,181
2018	2,622
Thereafter	1,772
<b>Total minimum lease payments</b>	<b>\$ 15,855</b>

Rent expense under operating leases for the three and nine months ended September 30, 2014 was \$1.0 million and \$2.4 million, respectively. Rent expense under operating leases for the three and nine months ended September 30, 2013 was \$0.5 million and \$1.4 million, respectively.

## 12. INCOME TAXES

The provision for income taxes is based on a current estimate of the annual effective income tax rate adjusted to reflect the impact of discrete items. Significant management judgment is required in estimating operating income in order to determine our estimated effective income tax rate. The effective income tax rate was 38.57% and 31.94% for the three months ended September 30, 2014 and 2013, respectively. The effective income tax rate was 39.11% and 32.02% for the nine months ended September 30, 2014 and 2013, respectively. The higher effective income tax rate for the three and nine months ended September 30, 2014 is primarily a result of our 2014 Reorganization, as the 2013 effective income tax rate only includes WCAS Holdings which has historically been treated as a consolidated corporation that is taxed under Subchapter C of the United States Internal Revenue Code of 1986, as amended (a Subchapter C Corporation ).

As a result of the 2014 Reorganization, we are treated as a Subchapter C Corporation and, therefore, subject to both federal and state income taxes. Holdings continues to be recognized as a wholly-owned partnership for income tax purposes. Accordingly, we recorded a one-time non-cash charge to equity of \$0.2 million during the nine months ended September 30, 2014 for the amount of the deferred tax liability resulting from the exchange of common units, incentive units and Series B Preferred Units of Holdings for common stock and restricted stock of Software as part of the 2014 Reorganization.

**Table of Contents**

Paycom Software, Inc.

Notes to the Condensed Consolidated Financial Statements

(in thousands, except share and per share amounts)

(unaudited)

**Pro Forma Income Tax Expense**

In connection with the 2014 Reorganization, we became taxed as a Subchapter C Corporation effective January 1, 2014. The pro forma net income applied in computing the pro forma EPS for the three and nine months ended September 30, 2013 is based on our historical net income as adjusted to reflect our conversion to a Subchapter C Corporation as if it had occurred as of January 1, 2013. The pro forma net income includes an adjustment to income tax expense, the amount of which was determined at an effective income tax rate of 46.9%, which resulted in an incremental pro forma income tax expense (benefit) of (\$0.1 million) and \$0.6 million for the three and nine months ended September 30, 2013, respectively.

**13. SUBSEQUENT EVENTS**

We had no material subsequent events that have not already been disclosed in the notes to these condensed consolidated financial statements.



---

**Table of Contents****Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

*This Management's Discussion and Analysis of Financial Condition and Results of Operations is intended to provide a reader of our financial statements with a narrative from the perspective of our management on our financial condition, results of operations, liquidity, and certain other factors that may affect our future results. The following discussion and analysis should be read in conjunction with: (i) the accompanying unaudited condensed consolidated financial statements and notes thereto for the three and nine months ended September 30, 2014, (ii) the consolidated financial statements and notes thereto for the year ended December 31, 2013 included in our final prospectus filed pursuant to Rule 424(b) (the Prospectus) with the Securities and Exchange Commission (the SEC) on April 15, 2014 and (iii) the discussion under the caption Management's Discussion and Analysis of Financial Condition and Results of Operations in our Prospectus. Aside from certain information as of December 31, 2013, all amounts herein are unaudited. Unless we state otherwise or the context otherwise requires, the terms we, us, our and the Company refer, prior to the 2014 Reorganization (as defined below), to Paycom Payroll Holdings, LLC and its consolidated subsidiaries (Holdings) and WCAS Paycom Holdings, Inc. (WCAS Holdings) collectively, and, after the 2014 Reorganization, to Paycom Software, Inc. (Software) and its consolidated subsidiaries. All amounts presented, other than share and per share amounts, are presented in thousands unless otherwise noted.*

**Forward-Looking Statements**

The following discussion contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 that are subject to risks and uncertainties. These statements are based on the beliefs of our management as well as the assumptions made by, and information currently available to, us. These statements include, but are not limited to, statements about our strategies, plans, objectives, expectations, intentions, expenditures, assumptions and other statements contained in this report that are not historical facts. When used in this document, words such as anticipate, believe, estimate, expect, intend, may, plan and project and similar expressions to us are intended to identify forward-looking statements. These statements include, without limitation, that our growth will generally mirror improvements in the labor market, that an increasing percentage of our recurring revenues will come from the sale of non-payroll and tax management human capital management (HCM) applications over time and result in improved gross margins, that our total gross margin will gradually improve over time as a result of additional clients, sale of additional applications to existing clients and reduced costs of revenues and administrative expenses, that our capital expenditures and investment activity will continue to increase, that we will fulfill our obligations under the agreement with the Oklahoma City Economic Development Trust, our plan and ability to open additional sales offices in the future, that our existing cash and cash equivalents will be sufficient to meet our working capital and capital expenditure needs over the next twelve months, and our expectation of increasing our capital expenditures and investment activity as our business grows.

These statements reflect our current views with respect to future events, which are not guarantees of future performance, and involve risks and uncertainties that are difficult to project. Further, certain forward-looking statements are based upon assumptions as to future events that may not prove to be accurate. Actual results could differ materially from those discussed in or implied by forward-looking statements as a result of various factors, including those discussed in our Prospectus filed with the SEC on April 15, 2014, and in particular the section entitled Risk Factors of the Prospectus. We disclaim any obligation to update any forward looking statements, whether as a result of new information, future events or otherwise. You should not rely upon forward-looking statements as predictions of future events or place undue reliance on such statements.

**Overview**

We are a leading provider of a comprehensive, cloud-based HCM software solution delivered as Software-as-a-Service ( SaaS ). We provide functionality and data analytics that businesses need to manage the complete employment life cycle from recruitment to retirement. Our solution requires virtually no customization and is based on a core system of record maintained in a single database for all HCM functions, including talent acquisition, time and labor management, payroll, talent management and human resources ( HR ) management applications. Our user-friendly software allows for easy adoption of our solution by employees, enabling self-management of their HCM activities in the cloud, which reduces the administrative burden on employers and increases employee productivity.

## **Table of Contents**

We serve a diverse client base in terms of size and industry. None of our clients constituted more than one-half of one percent of our revenues for the nine months ended September 30, 2014. We stored data for more than one million persons employed by our clients during the nine months ended September 30, 2014.

Our revenues are primarily generated through our sales force that solicits new clients and our client relations representatives ( CRRs ) who sell new applications to existing clients. We have 31 sales teams located in 20 states and plan to open additional sales offices to further expand our presence in the U.S. market. In recent years, we have opened three to four new sales offices in new cities per year and believe that we can increase this annual number to four to six new sales offices per year beginning in 2015. During the first nine months of 2014, we opened five new sales offices, with one sales office located in each of Baltimore, Indianapolis, Philadelphia, Portland and Silicon Valley. Our continued growth depends on attracting new clients through geographic expansion, further penetration of our existing markets and the introduction of new applications to our existing client base. We also expect a portion of our growth to generally mirror improvements in the labor market. Our principal marketing programs include telemarketing and email campaigns, search engine marketing methods and national radio advertising.

## **Recent Developments**

### ***Initial Public Offering***

On April 21, 2014, we closed our initial public offering ( IPO ) whereby an aggregate of 7,641,750 shares of our common stock were sold to the public (including 4,606,882 shares of common stock issued and sold by us and 3,034,868 shares of common stock sold by certain selling stockholders) at a public offering price of \$15.00 per share. We did not receive any proceeds from the sale of shares by the selling stockholders. The total gross proceeds we received from the offering were \$69.1 million. After deducting underwriting discounts and commissions and offering expenses payable by us, the aggregate net proceeds we received totaled approximately \$64.3 million. We used all of the net proceeds from the offering, together with approximately \$3.3 million from existing cash, for the repayment in full of the 10% Senior Note due 2022 (the 2022 Note ) issued by us to WCAS Capital Partners IV, L.P. and the 14% Note due 2017 issued by WCAS Holdings (the 2017 Note ).

### ***The Reorganization***

On January 1, 2014, we consummated a reorganization pursuant to which (i) affiliates of Welsh, Carson, Anderson & Stowe L.P. contributed WCAS Holdings and WCAS CP IV Blocker, Inc. ( CP IV Blocker ), which collectively own all of the Series A Preferred Units of Holdings, to Software in exchange for shares of common stock of Software and (ii) the owners of outstanding Series B Preferred Units of Holdings contributed their Series B Preferred Units for shares of common stock of Software. Immediately after these contributions, Paycom Software Merger Sub, LLC ( Merger Sub ), a wholly-owned subsidiary of Software, merged with and into Holdings with Holdings surviving the merger. Upon consummation of the merger, the remaining holders of outstanding common and incentive units of Holdings received shares of common stock of Software for their common and incentive units by operation of Delaware law, and Holdings' ownership interest in Software was cancelled. Outstanding common units, Series B Preferred Units and WCAS Holdings and CP IV Blocker were contributed to Software in exchange for, or converted into, 45,708,573 shares of common stock and 8,121,101 shares of restricted stock of Software. Following these transactions, all outstanding Series C Preferred Units were eliminated in an intercompany transaction between Holdings and WCAS Holdings, and we assumed the 2017 Note. Following the reorganization, Software became a holding company with its principal asset being the Series A Preferred Units of Holdings (collectively, the 2014 Reorganization ).

Software's acquisition of WCAS Holdings and Holdings under the 2014 Reorganization represented transactions under common control and were required to be retrospectively applied to the financial statements for all prior periods when the financial statements were issued for a period that included the date the transactions occurred. Therefore, our consolidated financial statements are presented as if WCAS Holdings and Holdings were wholly-owned subsidiaries in periods prior to the 2014 Reorganization. The acquisition of CP IV Blocker was not deemed to be a reorganization under common control and our historical consolidated financial statements for periods prior to January 1, 2014 include the ownership of a minority equity interest in CP IV Blocker, which was eliminated upon the acquisition of CP IV Blocker on January 1, 2014.

**Table of Contents****Trends, Opportunities and Challenges**

While we currently derive most of our revenues from our payroll and tax management application ( payroll processing ), we expect an increasing percentage of our recurring revenues to come from our additional HCM applications over time. Our payroll application is the foundation of our solution and all of our clients are required to utilize this application in order to access our other applications. We generate revenues from (i) fixed amounts charged per billing period or (ii) fixed amounts charged per billing period plus a fee per employee or transaction processed. We do not require clients to enter into long-term contractual commitments with us. Our billing period varies by client based on when they pay their employees, which is either weekly, bi-weekly, semi-monthly or monthly.

For the nine months ended September 30, 2014 and 2013, our gross margins were approximately 82% and 81%, respectively. We expect changes in our revenue mix to gradually improve gross margin over time as our current gross margin for our other HCM applications is higher than our gross margin for payroll processing. We expect that our total gross margin will gradually improve over time as (i) we add additional clients, (ii) our existing clients deploy additional HCM applications and (iii) we reduce our costs of revenues and administrative expenses as a percentage of total revenues.

**Key Metrics**

In addition to the financial statement metrics that we regularly monitor, we also monitor the following metrics to evaluate our business, measure our performance and identify trends affecting our business:

	<b>Nine Months Ended</b>	
	<b>September 30,</b>	
	<b>2014</b>	<b>2013</b>
	<b>(dollars in thousands)</b>	
<b>Key Performance Indicators:</b>		
Sales teams	31	25
Annualized new recurring revenue	\$ 39,017	\$ 27,734

*Sales Teams.* We monitor our sales professionals by the number of sales teams and each team is comprised of approximately seven to nine sales professionals. Certain larger metropolitan areas can support more than one sales team. We believe that the number of sales teams is an indicator of revenue for future periods.

*Annualized New Recurring Revenue.* While we do not enter into long-term contractual commitments with our clients, we monitor annualized new recurring revenue as we believe it is an indicator of revenue for future periods. Annualized new recurring revenue is an estimate based on the annualized amount of the first full month of revenue attributable to new clients that were added or existing clients that purchased additional applications during the period presented. Annualized new recurring revenue only includes revenues from clients who have used our solution for at least one month during the period. Since annualized new recurring revenue is only recorded after a client uses our solution for one month, it includes revenue that has been recognized in historical periods.



**Table of Contents**

Three months ended September 30, 2014 as compared to the three months ended September 30, 2013.

The following tables set forth selected Condensed Consolidated Statements of Income data and such data as a percentage of total revenues for the periods presented:

	<b>Three Months Ended September 30,</b>		
	<b>2014</b>	<b>2013</b>	<b>% Change</b>
<b>Revenues</b>			
Recurring	\$ 35,910	\$ 25,210	42.4%
Implementation and other	688	620	11.0%
Total revenues	36,598	25,830	41.7%
<b>Cost of revenues</b>			
Operating expenses	5,798	4,846	19.6%
Depreciation	638	494	29.1%
Total cost of revenues	6,436	5,340	20.5%
<b>Administrative expenses</b>			
Sales and marketing	14,856	10,339	43.7%
Research and development	1,059	538	96.8%
General and administrative	8,410	6,815	23.4%
Depreciation and amortization	1,159	959	20.9%
Total administrative expenses	25,484	18,651	36.6%
Total operating expenses	31,920	23,991	33.0%
Operating income	4,678	1,839	154.4%
Interest expense	(338)	(2,329)	-85.5%
Net loss on early repayment of debt			n/a
Other income (expense), net	39	(133)	-129.3%
Income (loss) before income taxes	4,379	(623)	-802.9%
Provision (benefit) for income taxes	1,689	(199)	-948.7%
Net income (loss)	\$ 2,690	\$ (424)	-734.4%

	<b>Three Months Ended September 30,</b>	
	<b>2014</b>	<b>2013</b>
<b>Revenues</b>		
Recurring	98.1%	97.6%
Implementation and other	1.9%	2.4%

Edgar Filing: Paycom Software, Inc. - Form 10-Q

Total revenues	100.0%	100.0%
<b>Cost of revenues</b>		
Operating expenses	15.8%	18.8%
Depreciation	1.7%	1.9%
Total cost of revenues	17.5%	20.7%
<b>Administrative expenses</b>		
Sales and marketing	40.6%	40.0%
Research and development	2.9%	2.1%
General and administrative	23.0%	26.4%
Depreciation and amortization	3.2%	3.7%
Total administrative expenses	69.7%	72.2%
Total operating expenses	87.2%	92.9%
Operating income	12.8%	7.1%
Interest expense	-0.9%	-9.0%
Net loss on early repayment of debt	0.0%	0.0%
Other income (expense), net	0.1%	-0.5%
Income (loss) before income taxes	12.0%	-2.4%
Provision (benefit) for income taxes	4.6%	-0.8%
Net income (loss)	7.4%	-1.6%



**Table of Contents*****Revenues***

Total revenues were \$36.6 million for the three months ended September 30, 2014 as compared to \$25.8 million for the three months ended September 30, 2013, an increase of \$10.8 million, or 41.7%. The increase in total revenues was primarily due to the addition of clients in mature sales offices (those offices that have been open for at least 24 months). A combination of other factors also contributed to the increase in revenues, including the addition of new clients in more recently opened sales offices, the introduction and sale of additional applications to our existing clients and the growth in the number of employees of our clients. The increase in revenues was also due to an increase in the average revenue per client as we continue to sell our applications to larger clients.

***Cost of Revenues***

Cost of revenues was \$6.4 million for the three months ended September 30, 2014 as compared to \$5.3 million for the three months ended September 30, 2013, an increase of \$1.1 million, or 20.5%. The increase in cost of revenues was due primarily to increases of \$0.8 million in employee costs related to additional operating personnel and \$0.2 million in increased shipping fees related to increased sales, which was partially offset by a decrease in bank fees of \$0.1 million due to a renegotiation of rates on bank fees for the third quarter of 2014. In addition, depreciation expense increased by \$0.1 million, an increase of 29.1%, primarily due to technology and other additional assets purchased.

***Administrative Expenses***

Total administrative expenses were \$25.5 million for the three months ended September 30, 2014 as compared to \$18.7 million for the three months ended September 30, 2013, an increase of \$6.8 million, or 36.6%. Sales and marketing expense increased by \$4.5 million primarily due to a \$2.2 million increase in employee-related expenses, resulting from a 31.0% increase in the number of sales personnel, a \$1.6 million increase in commission and bonuses resulting from increased sales, a \$0.5 million increase in building rent and security related to new offices and additional leased space in existing offices, a \$0.1 million increase in communications expense and a \$0.1 million increase in marketing and advertising. Research and development expense increased by \$0.6 million, primarily due to an increase in the number of research and development personnel and related bonus expense. We anticipate a gradual increase in research and development expense over time as we increase the number of research and development personnel. General and administrative expense increased by \$1.6 million primarily due to a \$1.1 million increase in employee-related expenses and an increase in accounting and compliance expense of \$0.5 million, related to the IPO and costs of operating as a public company. In addition, depreciation and amortization expense increased by \$0.1 million, an increase of 20.9%, primarily due to additional assets purchased.

Expenditures for software developed or obtained for internal use are capitalized and amortized over a three-year period on a straight-line basis. The timing of these capitalized expenditures may affect the amount of research and development expenses in any given period. The table below sets forth the amounts of capitalized and expensed research and development expenses for the three months ended September 30, 2014 and 2013:

	<b>Three Months Ended September 30,</b>	
	<b>2014</b>	<b>2013</b>
Capitalized portion of research and development	\$ 580	\$ 246
Expensed portion of research and development	1,059	538
<b>Total research and development</b>	<b>\$ 1,639</b>	<b>\$ 784</b>



**Table of Contents**

*Nine months ended September 30, 2014 as compared to the nine months ended September 30, 2013*

The following tables set forth selected Condensed Consolidated Statements of Income data and such data as a percentage of total revenues for the periods presented:

	<b>Nine Months Ended September 30,</b>		
	<b>2014</b>	<b>2013</b>	<b>% Change</b>
<b>Revenues</b>			
Recurring	\$ 105,030	\$ 75,808	38.5%
Implementation and other	1,859	1,513	22.9%
Total revenues	106,889	77,321	38.2%
<b>Cost of revenues</b>			
Operating expenses	17,847	13,633	30.9%
Depreciation	1,876	1,320	42.1%
Total cost of revenues	19,723	14,953	31.9%
<b>Administrative expenses</b>			
Sales and marketing	44,237	28,913	53.0%
Research and development	2,878	1,317	118.5%
General and administrative	25,816	18,851	36.9%
Depreciation and amortization	3,322	2,716	22.3%
Total administrative expenses	76,253	51,797	47.2%
Total operating expenses	95,976	66,750	43.8%
Operating income	10,913	10,571	3.2%
Interest expense	(3,079)	(6,929)	-55.6%
Net loss on early repayment of debt	(4,044)		n/a
Other income (expense), net	1,395	140	896.4%
Income (loss) before income taxes	5,185	3,782	37.1%
Provision (benefit) for income taxes	2,028	1,211	67.5%
Net income (loss)	\$ 3,157	\$ 2,571	22.8%

	<b>Nine Months Ended September 30,</b>	
	<b>2014</b>	<b>2013</b>
<b>Revenues</b>		
Recurring	98.3%	98.0%
Implementation and other	1.7%	2.0%

Edgar Filing: Paycom Software, Inc. - Form 10-Q

Total revenues	100.0%	100.0%
<b>Cost of revenues</b>		
Operating expenses	16.7%	17.6%
Depreciation	1.8%	1.7%
Total cost of revenues	18.5%	19.3%
<b>Administrative expenses</b>		
Sales and marketing	41.4%	37.4%
Research and development	2.7%	1.7%
General and administrative	24.2%	24.4%
Depreciation and amortization	3.1%	3.5%
Total administrative expenses	71.4%	67.0%
Total operating expenses	89.9%	86.3%
Operating income	10.2%	13.7%
Interest expense	-2.9%	-9.0%
Net loss on early repayment of debt	-3.8%	0.0%
Other income (expense), net	1.3%	0.2%
Income (loss) before income taxes	4.8%	4.9%
Provision (benefit) for income taxes	1.9%	1.6%
Net income (loss)	2.9%	3.3%

**Table of Contents*****Revenues***

Total revenues were \$106.9 million for the nine months ended September 30, 2014 as compared to \$77.3 million for the nine months ended September 30, 2013, an increase of \$29.6 million, or 38.2%. The increase in total revenues was primarily due to the addition of clients in mature sales offices (those offices that have been open for at least 24 months). A combination of other factors also contributed to the increase in revenues, including the addition of new clients in more recently opened sales offices, the introduction and sale of additional applications to our existing clients and the growth in the number of employees of our clients. The increase in revenues was also due to an increase in the average revenue per client as we continue to sell our applications to larger clients.

***Cost of Revenues***

Cost of revenues was \$19.7 million for the nine months ended September 30, 2014 as compared to \$15.0 million for the nine months ended September 30, 2013, an increase of \$4.7 million, or 31.9%. The increase in cost of revenues was due primarily to increases of \$3.0 million in employee costs related to additional operating personnel and \$0.5 million in increased shipping fees related to increased sales. In addition, depreciation expense increased by \$0.6 million, an increase of 42.1%, primarily due to additional technology and other assets purchased.

***Administrative Expenses***

Total administrative expenses were \$76.3 million for the nine months ended September 30, 2014 as compared to \$51.8 million for the nine months ended September 30, 2013, an increase of \$24.5 million, or 47.2%. Sales and marketing expense increased by \$15.3 million primarily due to a \$8.1 million increase in employee-related expenses, resulting from a 31.0% increase in the number of sales personnel, a \$3.7 million increase in commission and bonuses resulting from increased sales, a \$1.4 million increase in building rent and security related to new offices and additional leased space in existing offices, a \$0.7 million increase in travel expense related to additional travel from the new offices, and an increase in marketing expense of \$0.8 million primarily due to increased radio and print advertising. Research and development expense increased by \$1.6 million, primarily due to an increase in the number of research and development personnel and related bonus expense. We anticipate a gradual increase in research and development expense over time as we increase the number of research and development personnel. General and administrative expense increased by \$7.0 million primarily due to a \$3.4 million increase in employee-related expenses resulting from an increase in the number of general and administrative personnel, an increase in accounting and compliance expense of \$1.3 million related to the IPO and costs of operating as a public company, a \$0.2 million increase in expense related to the new corporate headquarters building, along with \$0.7 million of other increased general and administrative expenses related to the IPO. In addition, depreciation and amortization expense increased by \$0.6 million, an increase of 22.3%, primarily due to additional assets purchased.

Expenditures for software developed or obtained for internal use are capitalized and amortized over a three-year period on a straight-line basis. The timing of these capitalized expenditures may affect the amount of research and development expenses in any given period. The table below sets forth the amounts of capitalized and expensed research and development expenses for the nine months ended September 30, 2014 and 2013:

	<b>Nine Months Ended September 30,</b>	
	<b>2014</b>	<b>2013</b>
Capitalized portion of research and development	\$ 1,125	\$ 713
Expensed portion of research and development	2,878	1,315

Total research and development	\$	4,003	\$	2,028
--------------------------------	----	-------	----	-------

**Liquidity and Capital Resources**

As of September 30, 2014, our principal sources of liquidity were cash and cash equivalents totaling \$18.5 million. Our cash and cash equivalents are comprised primarily of deposit accounts and money market funds.

We have historically financed our operations from cash flows generated from operations, cash from the sale of debt and equity securities and borrowings under our consolidated loans. Since inception, we have raised \$125.1 million of equity capital, \$64.3 million of which was the net proceeds raised in our IPO that closed in April 2014. We have also incurred debt to finance the expansion of our corporate headquarters which was completed June 2014, as well as other previously constructed facilities, and incurred related party debt as part of a corporate reorganization in April 2012 and the 2014 Reorganization. As of September 30, 2014, our only outstanding indebtedness consisted of the 2021 Consolidated Loan, which is defined and discussed in more detail below.

## **Table of Contents**

*2021 Consolidated Loan.* As of September 30, 2014, we had a term note under a Loan Agreement (the 2021 Consolidated Loan ), with an outstanding principal amount of \$27.2 million due to Kirkpatrick Bank that matures on May 30, 2021. Under the 2021 Consolidated Loan, interest is payable monthly and accrues at a fixed rate of 4.75% per annum. The 2021 Consolidated Loan is secured by a mortgage covering our headquarters buildings and certain personal property relating to our headquarters buildings.

We are required to comply with certain financial and non-financial covenants under the 2021 Consolidated Loan, including maintaining a debt coverage ratio of EBITDA to indebtedness (defined as current maturities of long-term debt, interest expense and distributions) greater than 1.5 to 1.0. As of September 30, 2014, we were in compliance with all of the covenants under the 2021 Consolidated Loan.

Pursuant to the terms of the 2021 Consolidated Loan, we may not, subject to certain exceptions, until amounts under the 2021 Consolidated Loan are repaid: (i) create any mortgages or liens, (ii) make any loans, advances or extensions of credit with any affiliate or enter into any other transaction with any affiliate, (iii) lease any mortgaged property, (iv) make any distributions to members as long as an event of default exists, (v) make any material change in methods of accounting, (vi) enter into any sale and leaseback arrangement, (vii) amend, modify, restate, cancel or terminate our organizational documents, (viii) sell, transfer or convey any mortgaged property or (ix) incur funded outside debt.

An event of default under the 2021 Consolidated Loan includes, among other events, (i) failure to pay principal or interest when due, (ii) breaches of certain covenants, (iii) any failure to meet the required financial covenants and (iv) an institution of a bankruptcy, reorganization, liquidation or receivership.

Our cash flows from operating activities have historically been significantly impacted by profitability, implementation revenue received but deferred and our investments in sales and marketing to expand our operations. Our ability to meet future liquidity needs will be driven by our operating performance and the extent of continued investment in our operations. We believe our existing cash and cash equivalents will be sufficient to meet our working capital and capital expenditure needs over at least the next 12 months. Failure to generate sufficient revenue and cash flows from operations could have a material adverse effect on our ability to meet our liquidity needs and achieve our business objectives.

As part of our payroll and tax management application, we collect funds for federal, state and local employment taxes from our clients which we remit to the appropriate tax agencies. We invest these funds in short-term certificates of deposit and money market funds from which we earn interest income during the period between their receipt and disbursement.

Depending on certain growth opportunities, we may choose to accelerate investments in sales and marketing and technology and services. Actual future capital requirements will depend on many factors, including our future revenues, cash provided by operating activities and the level of expenditures in all areas of our business. As our business grows, we expect our capital expenditures and our investment activity to continue to increase.

## ***Cash Flow Analysis***

### ***Operating Activities***

Net cash provided by operating activities for the nine months ended September 30, 2014 was \$13.3 million. Net cash provided by operating activities consisted primarily of net income of \$3.2 million, depreciation and amortization of \$5.2 million, an increase in deferred revenues of \$4.7 million, a write off of debt issuance costs of \$4.1 million and deferred tax assets of \$1.3 million, offset by a decrease in accounts payable of \$3.0 million, unrealized change in the

fair value of our derivative liability of \$1.1 million and a decrease in accrued commissions and bonuses of \$1.0 million.

Net cash provided by operating activities for the nine months ended September 30, 2013 was \$12.1 million. Net cash provided by operating activities consisted primarily of net income of \$2.6 million, depreciation and amortization of \$4.0 million, an increase in deferred revenue of \$2.8 million, an increase in accrued expenses and other liabilities of \$2.7 million, a decrease in deferred tax assets of \$1.2 million and a decrease in stock-based compensation of \$0.9 million, offset by a decrease in accrued commissions and bonuses of \$1.2 million and an increase in prepaid expenses of \$0.8 million.



**Table of Contents***Investing Activities*

Net cash provided by investing activities for the nine months ended September 30, 2014 was \$50.2 million and resulted primarily from a decrease in funds held for clients of \$62.1 million offset by additions to property, plant and equipment of \$11.9 million.

Net cash provided by investing activities for the nine months ended September 30, 2013 was \$76.1 million and resulted primarily from a decrease in funds held for clients of \$82.3 million and additions to property, plant and equipment of \$6.2 million.

*Financing Activities*

Net cash used in financing activities for the nine months ended September 30, 2014 was \$58.4 million. Net cash used in financing activities primarily resulted from payments on long-term debt of \$65.4 million and a decrease in the clients funds obligation of \$62.1 million offset by proceeds from the IPO of \$62.8 million and proceeds from the issuance of long-term debt of \$6.5 million.

Net cash used in financing activities for the nine months ended September 30, 2013 was \$80.4 million. Net cash used in financing activities primarily resulted from a decrease in the client funds obligation of \$82.3 million and incentive awards redeemed of \$1.1 million, offset by payments on long-term debt of \$1.8 million and a capital contribution of \$1.2 million.

*Contractual Obligations*

Our principal commitments primarily consist of long-term debt and other creditors and leases for office space. For additional information regarding our long-term debt to related parties and our commitments and contingencies, see Note 5 Long Term Debt and Note 11 Commitments and Contingencies in the notes to our unaudited condensed consolidated financial statements included elsewhere in this report.

As of September 30, 2014, the future non-cancelable minimum payments under these commitments were as follows:

	Total	Payments Due by Period			
		Less than 1 Year	1-3 Years	3-5 Years	More than 5 Years
Long-term debt obligations <sup>(1)</sup>	\$ 27,186	\$ 845	\$ 1,813	\$ 2,000	\$ 22,528
Interest on the 2014 Consolidated Loan	7,773	1,289	2,456	2,269	1,759
Operating lease obligations:					
Facilities space	15,298	3,554	7,261	4,277	205
<b>Total</b>	<b>\$ 50,257</b>	<b>\$ 5,688</b>	<b>\$ 11,530</b>	<b>\$ 8,546</b>	<b>\$ 24,492</b>

(1) The amount represents principal of the 2021 Consolidated Loan due at maturity.

**Off-Balance Sheet Arrangements**

As of September 30, 2014, we did not have any off-balance sheet arrangements.

### **Critical Accounting Policies and Estimates**

Our condensed consolidated financial statements and accompanying notes have been prepared in accordance with accounting principles generally accepted in the United States of America ( U.S. GAAP ). The preparation of these condensed consolidated financial statements requires us to make estimates, judgments and assumptions that affect the reported amounts of assets, liabilities, revenues, costs and expenses, and related disclosures. On an ongoing basis, we continually evaluate our estimates and assumptions believed to be reasonable under current facts and circumstances. Actual amounts and results may materially differ from these estimates made by management under different assumptions and conditions.

**Table of Contents**

Certain accounting policies that require significant management estimates and are deemed critical to our results of operations or financial position, are discussed in the Critical Accounting Policies section of Management's Discussion and Analysis of Financial Condition and Results of Operations in the Prospectus filed with the SEC on April 15, 2014.

***Restricted Stock***

In connection with the 2014 Reorganization, incentive units in Holdings were converted into shares of common stock and/or restricted stock. Vested incentive units were converted to shares of common stock and restricted stock at various conversion ratios that ranged from approximately 1:0.2 to 1:24. Unvested incentive units were converted to shares of restricted stock at various conversion ratios that ranged from 1:24 to 1:47. The conversion to shares of common stock or restricted stock was determined based on the underlying conditions of the pre-conversion incentive units and reflected any pre-existing vesting conditions. This conversion resulted in the issuance of 1,148,520 and 8,121,101 shares of common stock and restricted stock, respectively, on January 1, 2014. The shares of restricted stock are subject to either time-based or performance-based vesting conditions. FASB Accounting Standards Codification (ASC) Section 718-20-53-3 indicates that if the terms and conditions of an existing equity incentive compensation plan are to be modified, then an entity should record additional compensation cost for any incremental value associated with the modification. The incremental compensation cost is measured as the excess of the fair value of the modified awards over the fair value of the original awards immediately before its terms are modified. Based on the terms of restricted stock, the Company concluded that there was a modification of the existing equity incentive units. Based upon a valuation by an independent third party, management determined there was no additional compensation cost created in the conversion, as the value of the incentive units given up was less than the value of the restricted stock received. As such, there was no additional compensation recorded.

Given the absence of a public trading market for our common stock prior to our IPO, and in accordance with the American Institute of Certified Public Accountants (the AICPA), Audit and Accounting Practice Aid Series: Valuation of Privately Held Company Equity Securities Issued as Compensation (the AICPA Practice Guide), our board of directors exercised reasonable judgment and considered numerous factors to determine the best estimate of the fair value of our restricted stock, including:

Valuation analyses performed by an unrelated third party specialist (including the application of appropriate valuation techniques and inputs);

Characteristics and specific terms of the shares as noted in the equity grant agreements;

Value of the shares as determined by the absence of a liquidation value on the date of grant, the ability to participate in our future profits, growth and appreciation and the lack of an exercise price for the shares;

Lack of marketability of our common stock;

Our actual operating and financial performance;

Our state of development;

Revenue and expense projection;

Likelihood of achieving a liquidating event;

Market performance of comparable publicly traded companies; and

Overall U.S. and global economic and capital market conditions.

**Table of Contents**

Our simulation model requires various subjective assumptions as inputs, including expected life, volatility, risk-free interest rates and the expected dividend yield. The assumptions used in the simulation model represent our best estimates, which involve inherent uncertainties and the application of judgment as follows:

*Risk-free interest rate* We base the risk-free interest rate used in the Monte Carlo simulation model on the implied yield available on 5 year U.S. Treasury securities with a remaining term equivalent to that of the respective shares as of the valuation date.

*Volatility* We determine the volatility factor based on the historical volatilities of comparable guideline companies. To determine the comparable guideline companies, we consider cloud-based application providers and select those that are similar in nature to us in the nature of services provided. We intend to continue to consistently apply this process using the same or similar public companies until information regarding the volatility of our own pricing becomes available, or unless circumstances change such that the identified companies are no longer similar to us, in which case, more suitable companies whose share prices are publicly available would be utilized in the calculation.

*Expected Term* The expected term represents the period that our restricted stock is expected to be outstanding. We determine the expected term assumption based on the vesting terms and contractual terms of the restricted stock.

*Expected dividend yield* We have not paid and do not expect to pay dividends in the future and therefore an expected dividend yield of 0% was applied. Our directors will determine if and when dividends will be declared and paid in the future based on our financial position at the relevant time.

The following table represents a summary of the grant-date fair values of restricted stock based on the Monte Carlo simulation model and the related assumptions as of September 30, 2014:

	<b>Nine Months Ended</b>	
	<b>September 30,</b>	
	<b>2014</b>	<b>2013</b>
Grant-date fair value		
2012 Management Incentive Units		\$4.67 - \$19.49
2014 Restricted Stock	\$5.76 - \$36.03	
Risk-free interest rates	1.02%	0.71% - 0.79%
Estimated Volatility	30.0%	50.0%
Expected life (in years)	3.5	5.0

In addition to the assumptions used in the simulation model, we are required to estimate forfeitures and only record compensation costs for restricted stock that is expected to vest. Our forfeiture estimate is based on an analysis of our own actual forfeitures. We will continue to evaluate the appropriateness of the forfeiture rate based on actual forfeiture experience, analysis of employee turnover and other factors.

**Non-GAAP Financial Measures**

## Edgar Filing: Paycom Software, Inc. - Form 10-Q

We use earnings before interest, taxes, depreciation and amortization ( EBITDA ), Adjusted EBITDA and non-GAAP net income (loss), as supplemental measures to review and assess our performance and planning purposes. We define: (i) EBITDA as net income (loss), plus interest expense, taxes and depreciation and amortization, (ii) Adjusted EBITDA as net income (loss), plus interest expense, taxes, depreciation and amortization, stock-based compensation expense, net loss on early extinguishment of debt and certain transaction expenses that are not core to our operations and (iii) non-GAAP net income (loss) as pro forma net income plus tax adjusted stock-based compensation expense, tax adjusted net loss on early extinguishment of debt and certain tax adjusted transaction expenses that are not core to our operations. EBITDA, Adjusted EBITDA and non-GAAP net income (loss) are metrics that we believe are useful to investors in evaluating our performance and facilitating comparison with other peer companies, many of which use similar non-GAAP financial measures to supplement results under U.S. GAAP.

EBITDA, Adjusted EBITDA and non-GAAP net income (loss) are not measures of financial performance under U.S. GAAP, and should not be considered a substitute for net income (loss) or pro forma net income (loss), as applicable, which we consider to be the most directly comparable U.S. GAAP measures. EBITDA, Adjusted EBITDA and non-GAAP net income (loss) have limitations as analytical tools, and when assessing our operating performance, you should not consider EBITDA, Adjusted EBITDA or non-GAAP net income (loss) in isolation, or as a substitute for net income (loss), pro forma net income (loss) or other Condensed Consolidated Statements of Income data prepared in accordance with U.S. GAAP. EBITDA, Adjusted EBITDA and non-GAAP net income (loss) may not be comparable to similar titled measures of other companies and other companies may not calculate such measures in the same manner as we do.

The following tables reconcile net income (loss) to EBITDA and Adjusted EBITDA and pro forma net income (loss) to non-GAAP net income (loss):

**Table of Contents**

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
<b>Consolidated statements of income data:</b>				
Net income (loss)	\$ 2,690	\$ (424)	\$ 3,157	\$ 2,571
Interest expense	338	2,329	3,079	6,929
Taxes	1,689	(199)	2,028	1,211
Depreciation and amortization	1,797	1,453	5,198	4,036
EBITDA	6,514	3,159	13,462	14,747
Stock-based compensation expense	88	81	362	925
Transaction expenses		532	1,363	663
Net loss on early extinguishment of debt			4,044	
Adjusted EBITDA	\$ 6,602	\$ 3,772	\$ 19,231	\$ 16,335

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
<b>Consolidated statements of income data:</b>				
Pro forma net income (loss)	\$ 2,690	\$ (328)	\$ 3,157	\$ 1,989
Tax adjusted stock-based compensation expense	51	43	211	491
Tax adjusted transaction expenses		282	795	352
Tax adjusted net loss on early extinguishment of debt			2,358	
Non-GAAP net income (loss)	\$ 2,741	\$ (3)	\$ 6,521	\$ 2,832
Non-GAAP net income (loss) per share, basic	\$ 0.05	\$ (0.00)	\$ 0.13	\$ 0.06
Non-GAAP net income (loss) per share, diluted	\$ 0.05	\$ (0.00)	\$ 0.13	\$ 0.06
<b>Pro Forma weighted average shares outstanding:</b>				
Basic	51,056,462	45,707,802	49,040,344	45,398,933
Diluted	52,978,051	45,707,802	51,223,048	47,975,548

**Item 3. Quantitative and Qualitative Disclosures About Market Risk.****Interest Rate Sensitivity**

We had cash and cash equivalents totaling \$18.5 million as of September 30, 2014. We consider all highly liquid debt instruments purchased with a maturity date of three months or less and money market mutual funds to be cash equivalents. This amount was invested primarily in deposit accounts and money market funds. The cash and cash equivalents are held for working capital purposes. Our investments are made for capital preservation purposes. We do not enter into investments for trading or speculative purposes.

Our cash equivalents are subject to market risk due to changes in interest rates. Fixed rate securities may have their market value adversely affected due to a rise in interest rates, while floating rate securities may produce less income than expected if interest rates fall. Due in part to these factors, our future investment income may fall short of expectations due to changes in interest rates, or we may suffer losses if we are forced to sell securities that decline in market value due to changes in interest rates.

We do not believe that an increase or decrease in interest rates of 100-basis points would have a material effect on our operating results or financial condition with respect to our cash and cash equivalents.

#### **Item 4. Controls and Procedures.**

##### **Evaluation of Disclosure Controls and Procedures**

As required by Rule 13a-15(b) and Rule 15d-15(b) under the Securities Exchange Act of 1934, as amended (the Exchange Act ), our management, including our Chief Executive Officer and Chief Financial Officer, evaluated, as of September 30, 2014, the effectiveness of our disclosure controls and procedures as defined in Rule 13a-15(e) and Rule 15d-15(e) under the Exchange Act. Based on that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of September 30, 2014 to provide reasonable assurance that information required to be disclosed by us in this report is recorded, processed, summarized and reported within the time periods specified by the rules and forms of the Exchange Act and is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosures.

We believe, however, that a controls system, no matter how well designed and operated, cannot provide absolute assurance that the objectives of the controls systems are met, and no evaluation of controls can provide absolute assurance that all control issues and instances of fraud or error, if any, within a company have been detected.



**Table of Contents**

**Changes in Internal Control over Financial Reporting**

There have been no changes in internal control over financial reporting that occurred during the quarter ended September 30, 2014 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**Table of Contents**

**PART II**

**OTHER INFORMATION**

**Item 1. Legal Proceedings.**

In July 2013, Dr. Lakshmi Arunachalam filed a complaint against Paycom Payroll, LLC ( Paycom ) in the U.S. District Court for the District of Delaware alleging that Paycom infringes on U.S. Patent No. 8,244,833 assigned to her. Paycom denied all claims made against it by Dr. Arunachalam in her complaint, asserted various defenses and counterclaims for non-infringement and challenged the validity and enforceability of U.S. Patent No. 8,244,833. The initial lawsuit was dismissed and a complaint was filed by Pi-Net International, Inc. on April 18, 2014, along with the claims of infringement of two additional patents, U.S. Patent No. 5,987,500 and U.S. Patent No. 8,108,492. On July 1, 2014, Paycom, Webexchange, Inc., Dr. Arunachalam, and Pi-Net International, Inc. entered into a confidential settlement agreement. As part of this settlement agreement, Pi-Net International, Inc. and Paycom entered a stipulation of dismissal with prejudice on July 1, 2014.

On September 23, 2014, we filed a complaint against National Financial Partners Corp. in the United States District Court for the Western District of Oklahoma (Civil Action No. 5:14-cv-01029-R) seeking a declaratory judgment that we have not engaged in any trademark infringement or unfair competition in connection with the use of our logo. On September 23, 2014, National Financial Partners Corp. filed a complaint against Software in the United States District Court for the Northern District of Illinois (Civil Action No. 1:14-cv-07424). The complaint alleges trademark infringement, unfair competition, deceptive trade practices, consumer fraud and deceptive business practices related to the adoption and use of our logo and seeks an injunction prohibiting us from continued infringement as well as money damages, including an accounting for sales and profits, attorneys' fees and disgorgement of profits. On October 20, 2014, we filed a motion to transfer the action from the Northern District of Illinois to the Western District of Oklahoma, and a memorandum in support of the motion to transfer, in the Northern District of Illinois. We intend to vigorously defend this litigation. In the event that a court ultimately determines that we have infringed any of the asserted trademarks, we may be subject to damages, which may include treble damages, and/or an injunction that could cause us to modify our logo and/or undergo a rebranding of our solution and applications. We cannot predict with any degree of certainty the outcome of the litigation or determine the extent of any potential liability or damages.

We are involved in various other legal proceedings in the ordinary course of business. Although we cannot predict the outcome of these proceedings, legal matters are subject to inherent uncertainties and there exists the possibility that the ultimate resolution of these matters could have a material adverse effect on our business, financial condition, results of operations or cash flows.

**Item 1A. Risk Factors.**

There have been no material changes from the risk factors set forth in our Prospectus filed with the SEC on April 15, 2014, which are incorporated by reference herein.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.**

**Recent Sales of Unregistered Securities**

Effective January 1, 2014, we issued 30,452,458 and 136,015 shares of our common stock to Welsh, Carson, Anderson & Stowe X, L.P. and WCAS Management Corporation, respectively, in exchange for the contribution of all of the shares of common stock of WCAS Holdings to Software. In addition, we issued 323,307 shares of our common

stock to WCAS Capital Partners IV, L.P. in exchange for the contribution of all of the shares of common stock of CP IV Blocker to Software.

Effective January 1, 2014, we issued 628,745 shares of our common stock to Robert J. Levenson (and certain affiliated entities) in exchange for his contribution of 200 Series B Preferred Units of Holdings to Software and we issued 220,060 shares of our common stock to Richard Aiello in exchange for his contribution of 70 Series B Preferred Units of Holdings to Software.

Effective January 1, 2014, pursuant to the Agreement and Plan of Merger by and among Software, Paycom, Holdings and Merger Sub, Merger Sub merged with and into Holdings, with all outstanding common units and incentive units of Holdings being converted into shares of our common stock or restricted stock by operation of Delaware law.

The sales of the above securities were deemed exempt from registration under Section 4(a)(2) or Regulation D of the Securities Act of 1933, as amended (the Securities Act ), as a transaction not involving a public offering. All of the foregoing securities are deemed restricted securities for purposes of the Securities Act. The recipients of securities in the transactions exempt under Section 4(a)(2) or Regulation D of the Securities Act represented their intention to acquire the securities for investment purposes only and not with a view to or for sale in connection with any distribution thereof and appropriate legends were affixed to shares of common stock or restricted stock issued in such transactions.

**Table of Contents**

**Share Repurchase Program**

During the period covered by this Quarterly Report on Form 10-Q, we did not have a share repurchase program in place, and no shares of our common stock were repurchased.

**Item 3. Defaults Upon Senior Securities.**

None.

**Item 4. Mine Safety Disclosures.**

None.

**Item 5. Other Information.**

None.

**Item 6. Exhibits**

The following exhibits are incorporated herein by reference or are filed with this Quarterly Report on Form 10-Q, in each case as indicated therein (number in accordance with Item 601 of Regulation S-K):

<b>Exhibit No.</b>	<b>Description</b>
2.1	Merger Agreement, by and among Paycom Software, Inc., Paycom Payroll Holdings, LLC, Paycom Payroll, LLC and Paycom Merger Sub, LLC, dated December 30, 2013 (incorporated by reference to Exhibit 2.4 to the Company's Registration Statement on Form S-1 dated March 10, 2014, filed with the SEC on March 10, 2014).
2.2	Contribution Agreement, by and between WCAS Capital Partners, IV, L.P. and Paycom Software, Inc., dated December 30, 2013 (incorporated by reference to Exhibit 2.5 to the Company's Registration Statement on Form S-1 dated March 10, 2014, filed with the SEC on March 10, 2014).
2.3	Contribution Agreement, by and among Welsh, Carson, Anderson & Stowe X, L.P., WCAS Management Corporation and Paycom Software, Inc., dated December 30, 2013 (incorporated by reference to Exhibit 2.6 to the Company's Registration Statement on Form S-1 dated March 10, 2014, filed with the SEC on March 10, 2014).
2.4	Contribution Agreement, by and among Paycom Software, Inc. and each of the signatories thereto, dated December 30, 2013 (incorporated by reference to Exhibit 2.7 to the Company's Registration Statement on Form S-1 dated March 10, 2014, filed with the SEC on March 10, 2014).
3.1	Amended and Restated Certificate of Incorporation of Paycom Software, Inc. (incorporated by reference to Exhibit 3.1 to the Company's Amendment No. 1 to the Registration Statement on Form S-1/A dated March 31, 2014, filed with the SEC on March 31, 2014).
3.2	Bylaws of Paycom Software, Inc. (incorporated by reference to Exhibit 3.2 to the Company's Amendment No. 1 to the Registration Statement on Form S-1/A dated March 31, 2014, filed with the SEC on March 31, 2014).

Edgar Filing: Paycom Software, Inc. - Form 10-Q

- 4.1 Form of Common Stock Certificate (incorporated by reference to Exhibit 4.1 to the Company's Amendment No. 1 to the Registration Statement on Form S-1/A dated March 31, 2014, filed with the SEC on March 31, 2014).
- 4.2 Amended and Restated Stockholders' Agreement (incorporated by reference to Exhibit 4.2 to the Company's Registration Statement on Form S-1 dated March 10, 2014, filed with the SEC on March 10, 2014).
- 4.3 Registration Rights Agreement (incorporated by reference to Exhibit 4.3 to the Company's Registration Statement on Form S-1 dated March 10, 2014, filed with the SEC on March 10, 2014).

**Table of Contents**

<b>Exhibit No.</b>	<b>Description</b>
10.1	First Loan Modification Agreement, by and between Kirkpatrick Bank and Paycom Payroll, LLC, dated December 31, 2013 (incorporated by reference to Exhibit 10.1 to the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2014, filed with the SEC on August 8, 2014).
10.2	Second Loan Modification Agreement, by and between Kirkpatrick Bank and Paycom Payroll, LLC, dated June 17, 2014 (incorporated by reference to Exhibit 10.2 to the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2014, filed with the SEC on August 8, 2014).
10.3	4.75% Consolidated, Amended, Restated and Increased Promissory Note, by and between Kirkpatrick Bank and Paycom Payroll, LLC, dated June 17, 2014 (incorporated by reference to Exhibit 10.3 to the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2014, filed with the SEC on August 8, 2014).
31.1*	Certification of the Chief Executive Officer of the Company, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2*	Certification of the Chief Financial Officer of the Company, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1**	Certification of the Chief Executive Officer and Chief Financial Officer of the Company, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101.INS*	XBRL Instance Document.
101.SCH*	XBRL Taxonomy Extension Schema Document.
101.CAL*	XBRL Taxonomy Calculation Linkbase Document.
101.DEF*	XBRL Taxonomy Definition Linkbase Document.
101.LAB*	XBRL Taxonomy Label Linkbase Document.
101.PRE*	XBRL Taxonomy Presentation Linkbase Document.

\* Filed herewith.

\*\* The certifications attached as Exhibit 32.1 are not deemed filed with the Securities and Exchange Commission and are not to be incorporated by reference into any filing of Paycom Software, Inc. under the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended, whether made before or after the date of this Quarterly Report on Form 10-Q, irrespective of any general incorporation language contained in such filing.

**Table of Contents**

**SIGNATURES**

Pursuant to the requirements of the Securities Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

**PAYCOM SOFTWARE, INC.**

Date: November 7, 2014

By: /s/ Chad Richison  
Chad Richison  
Chief Executive Officer and Director  
(Principal Executive Officer)

Date: November 7, 2014

By: /s/ Craig E. Boelte  
Craig E. Boelte  
Chief Financial Officer  
(Principal Financial Officer)