PEGASYSTEMS INC
Form 10-Q
May 10, 2011
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

x **Quarterly Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

For the quarterly period ended March 31, 2011

or

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

For the transition period from ________ to ________

Commission File Number: 1-11859

PEGASYSTEMS INC.

(Exact name of Registrant as specified in its charter)

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

(617) 374-9600

(Registrant s telephone number including area code)

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

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

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

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

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

There were 37,346,921 shares of the Registrant s common stock, $.01 par value per share, outstanding on May 2, 2011.

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PEGASYSTEMS INC.

UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands)

	As of March 31, 2011	As of December 31, 2010
ASSETS		
Current assets:		
Cash and cash equivalents	$ 56,352	$ 71,127
Marketable securities	20,463	16,124
Total cash, cash equivalents, and marketable securities	76,815	87,251
Trade accounts receivable, net of allowance of $1,570 and $1,159	108,739	79,896
Deferred income taxes	4,810	4,770
Income taxes receivable	9,840	9,266
Other current assets	8,448	7,473
Total current assets	208,652	188,656
Property and equipment, net	10,879	11,010
Long-term deferred income taxes	33,687	33,769
Long-term other assets	2,861	2,905
Intangible assets, net	77,814	80,684
Goodwill	20,451	20,451
Total assets	$ 354,344	$ 337,475
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 7,228	6,286
Accrued expenses	25,797	24,736
Accrued compensation and related expenses	18,299	27,125
Deferred revenue	75,884	56,903
Total current liabilities	127,208	115,050
Income taxes payable	5,919	5,783
Long-term deferred revenue	16,373	17,751
Other long-term liabilities	2,873	3,221
Total liabilities	152,373	141,805
Commitments and contingencies		
Stockholders equity:		
Preferred stock, 1,000 shares authorized; no shares issued and outstanding		
Common stock, 70,000 shares authorized; 37,329 shares and 37,250 issued and outstanding	373	372
Additional paid-in capital	124,024	122,607
Retained earnings	75,042	71,431
Accumulated other comprehensive income	2,532	1,260
Total stockholders equity	201,971	195,670

Total liabilities and stockholders equity	$ 354,344	$ 337,475

See notes to unaudited condensed consolidated financial statements.

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PEGASYSTEMS INC.

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(in thousands, except per share amounts)

	Three Months Ended March 31,	
Revenue:	**2011**	**2010**
Software license	$ 33,462	$ 30,343
Maintenance	27,448	15,086
Professional services	41,450	29,655
Total revenue	102,360	75,084
Cost of revenue:		
Cost of software license	1,674	31
Cost of maintenance	3,374	1,937
Cost of professional services	34,968	24,468
Total cost of revenue	40,016	26,436
Gross profit	62,344	48,648
Operating expenses:		
Selling and marketing	34,036	21,893
Research and development	15,133	11,626
General and administrative	7,132	5,059
Acquisition-related costs	338	1,508
Restructuring costs	141	
Total operating expenses	56,780	40,086
Income from operations	5,564	8,562
Foreign currency transaction gain (loss)	1,016	(3,074)
Interest income, net	86	565
Other income, net	28	241
Income before provision for income taxes	6,694	6,294
Provision for income taxes	1,963	2,443
Net income	$ 4,731	$ 3,851
Earnings per share		
Basic	$ 0.13	$ 0.10
Diluted	$ 0.12	$ 0.10

Weighted-average number of common shares outstanding

Basic	37,276	36,873
Diluted	38,803	38,702
Cash dividends declared per share	$ 0.03	$ 0.03

See notes to unaudited condensed consolidated financial statements.

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PEGASYSTEMS INC.

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

	Three Months Ended March 31,	
	2011	**2010**
Operating activities:		
Net income	$ 4,731	$ 3,851
Adjustment to reconcile net income to cash (used in) provided by operating activities:		
Excess tax benefits from exercise or vesting of equity awards	(1,077)	(3,906)
Deferred income taxes	142	123
Depreciation and amortization	4,011	844
Amortization of investments	87	900
Realized gain on sale of investments	-	(242)
Stock-based compensation expense	2,535	1,446
Foreign currency transaction (gain) loss	66	-
Other	400	316
Change in operating assets and liabilities:		
Trade accounts receivable	(28,412)	(2,819)
Income taxes receivable	(574)	(1,754)
Other current assets	175	752
Accounts payable and accrued expenses	(7,011)	(3,992)
Deferred revenue	17,223	9,259
Other long-term assets and liabilities	(411)	46
Cash (used in) provided by operating activities	(8,115)	4,824
Investing activities:		
Purchase of marketable securities	(9,026)	(49,005)
Matured and called marketable securities	4,738	25,280
Sale of marketable securities	-	160,372
Contingent consideration paid for an acquisition in 2008	-	(250)
Investment in property and equipment	(1,090)	(1,926)
Cash (used in) provided by investing activities	(5,378)	134,471
Financing activities:		
Issuance of common stock for share-based compensation plans	356	630
Excess tax benefits from exercise or vesting of equity awards	1,077	3,906
Dividend payments to shareholders	(1,118)	(1,105)
Common stock repurchases for tax withholdings for net settlement of equity awards	(1,517)	(3,410)
Common stock repurchases under share repurchase programs	(1,032)	(1,621)
Cash used in financing activities	(2,234)	(1,600)
Effect of exchange rate on cash and cash equivalents	952	(487)
Net (decrease) increase in cash and cash equivalents	(14,775)	137,208
Cash and cash equivalents, beginning of period	71,127	63,857
Cash and cash equivalents, end of period	$ 56,352	$ 201,065

See notes to unaudited condensed consolidated financial statements.

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PEGASYSTEMS INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. ACCOUNTING POLICIES

Basis of Presentation

The Company has prepared the accompanying unaudited condensed consolidated financial statements pursuant to the rules and regulations of the Securities and Exchange Commission (SEC) regarding interim financial reporting. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America (U.S.) for complete financial statements and should be read in conjunction with the Company s audited financial statements included in the Annual Report on Form 10-K for the year ended December 31, 2010.

In the opinion of management, the Company has prepared the accompanying unaudited condensed consolidated financial statements on the same basis as its audited financial statements, and these financial statements include all adjustments, consisting only of normal recurring adjustments, necessary for a fair presentation of the results of the interim periods presented. The operating results for the interim periods presented are not necessarily indicative of the results expected for the full year 2011.

During the first quarter of 2011, the Company recorded adjustments to the purchase price allocation of its acquisition of Chordiant. As required by applicable business combination accounting rules, these adjustments were applied retrospectively. Therefore, other current assets, long-term other assets, goodwill, accrued expenses, and deferred tax assets have been revised as of December 31, 2010 to reflect these adjustments. These revisions did not have any impact on the Company s previously reported results of operations or cash flows. See Note 5 Acquisition, Goodwill, and Other Intangible Assets for further discussion of these adjustments.

2. MARKETABLE SECURITIES

(in thousands)	**March 31, 2011**			
	Amortized Cost	**Unrealized Gains**	**Unrealized Losses**	**Fair Value**
Marketable securities:				
Government sponsored enterprise bonds	$ 5,001		(18)	$ 4,983
Corporate bonds	5,388	20	(7)	5,401
Commercial paper	1,998			1,998
Municipal bonds	8,089	5	(13)	8,081
Marketable securities	$ 20,476	25	(38)	$ 20,463

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

All of the Company s investments are classified as available-for-sale and are carried at fair value with unrealized gains and losses recorded as a component of accumulated other comprehensive income. As of March 31, 2011, remaining maturities of marketable debt securities ranged from May 2011 to January 2014, with a weighted-average remaining maturity of approximately 18 months. No available-for-sale securities were sold during the first quarter of 2011. Proceeds from available-for-sale securities sold during the first quarter of 2010 were $160.4 million with gross realized gains of approximately $0.3 million and gross realized losses of approximately $0.1 million. Specific identification of the individual securities was used to determine the basis on which the gain or loss was calculated.

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3. FAIR VALUE MEASUREMENTS

Assets Measured at Fair Value on a Recurring Basis

The Company s investments classified within Level 1 of the fair value hierarchy are valued using quoted market prices. The Company s investments classified within Level 2 of the fair value hierarchy are valued based on matrix pricing compiled by third party pricing vendors, using observable market inputs such as interest rates, yield curves, and credit risk.

The fair value hierarchy of the Company s cash equivalents and marketable securities at fair value is as follows:

		Fair Value Measurements at Reporting Date Using	
(in thousands)	March 31, 2011	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)
Money market funds	$ 10,344	$ 10,344	$
Marketable securities:			
Government sponsored enterprise bonds	$ 4,983	$	$ 4,983
Corporate bonds	5,401	5,401	
Commercial paper	1,998		1,998
Municipal bonds	8,081	2,091	5,990
Total marketable securities	$ 20,463	$ 7,492	$ 12,971

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

Assets Measured at Fair Value on a Nonrecurring Basis

Assets not recorded at fair value on a recurring basis, such as property and equipment and intangible assets, are recognized at fair value when they are impaired. During the first quarter of 2011 and 2010, the Company did not recognize any nonrecurring fair value measurements from impairments. The Company recorded assets acquired and liabilities assumed related to its acquisition of Chordiant at fair value as described in Note 5 Acquisition, Goodwill, and Other Intangible Assets.

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4. TRADE ACCOUNTS RECEIVABLE, NET OF ALLOWANCES

(in thousands)	March 31, 2011	December 31, 2010
Trade accounts receivable	$ 91,504	$ 65,373
Unbilled accounts receivable	18,805	15,682
Total accounts receivable	110,309	81,055
Allowance for doubtful accounts	(137)	(132)
Allowance for sales credit memos	(1,433)	(1,027)
Total allowance	(1,570)	(1,159)
	$ 108,739	$ 79,896

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

5. ACQUISITION, GOODWILL, AND OTHER INTANGIBLE ASSETS

Chordiant Acquisition

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

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

As of March 31, 2011, the Company recorded adjustments to the purchase price allocation to reflect the Company s final determination of other accrued liabilities, acquired tax assets and uncertain tax liabilities. As a result of this determination, the Company recorded a $1.8 million decrease to other accrued liabilities, a $0.4 million increase to net deferred tax assets, and a corresponding $2.2 million decrease to goodwill. See Note 9 Commitment and Contingencies for further discussion. These purchase price adjustments are also reflected retrospectively as of December 31, 2010 in the accompanying condensed consolidated balance sheet as required by the business combination accounting rules.

As of March 31, 2011, as a result of the purchase price allocation, the Company recorded approximately $18.1 million of goodwill, which was primarily due to the expected synergies of the combined entities and the workforce in place. The goodwill created by the transaction was nondeductible for tax purposes. A summary of the purchase price allocation for the acquisition of Chordiant is as follows:

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(in thousands)		
Total purchase consideration:		
Cash	$	156,832
Stock options		3,519
Total purchase consideration	$	160,351

Allocation of the purchase consideration:		
Cash	$	47,604
Accounts receivable, net of allowance		14,231
Other assets		2,659
Property and equipment		753
Deferred tax assets, net		26,927
Identifiable intangible assets		88,049
Goodwill		18,061
Accounts payable		(5,303)
Accrued liabilities		(12,054)
Deferred maintenance revenue		(17,863)
Long-term liabilities		(2,713)
Net assets acquired	$	160,351

The valuation of the assumed deferred maintenance revenue was based on the Company s contractual commitment to provide post-contract customer support to Chordiant customers. The fair value of this assumed liability was based on the estimated cost plus a reasonable margin to fulfill these service obligations. The majority of the deferred revenue is expected to be recognized in the 12 months following the acquisition.

The valuation of the acquired intangible assets is inherently subjective and relies on significant unobservable inputs. The Company used an income approach to value the acquired customer related intangible assets, technology and trade name. The valuation for each of these intangible assets was based on estimated projections of expected cash flows to be generated by the assets, discounted to the present value at discount rates commensurate with perceived risk. The valuation assumptions take into consideration the Company s estimates of contract renewal, technology attrition and revenue growth projections.

The acquired intangibles are being amortized over a weighted-average period of 8.4 years on a straight-line basis. The values for specifically identifiable intangible assets, by major asset class, are as follows:

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

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Pro forma Information

The following pro forma financial information presents the combined results of operations of the Company and Chordiant as if the acquisition had occurred on January 1, 2009 after giving effect to certain pro forma adjustments. The pro forma adjustments reflected herein include only those adjustments that are directly attributable to the Chordiant acquisition, factually determinable, and expected to have a continuing impact on the Company. These pro forma adjustments include a reduction of historical Chordiant revenue for fair value adjustments related to acquired deferred revenue and elimination of deferred costs associated with revenue, a net increase in amortization expense to eliminate historical amortization of Chordiant intangible assets and to record amortization expense for the $88 million of acquired identifiable intangibles. The pro forma financial information does not reflect any adjustments for anticipated synergies resulting from the acquisition and is not necessarily indicative of the operating results that would have actually occurred had the transaction been consummated as of January 1, 2009.

	Pro Forma Three Months Ended March 31, 2010
Revenue	$ 91,844
Net loss	(1,422)
Net loss per basic and diluted share	$ (0.04)