BLACKBAUD INC
Form 10-Q
November 04, 2013

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

FORM 10-Q

ý QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2013
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: 000-50600

BLACKBAUD, INC.
(Exact name of registrant as specified in its charter)

Delaware	11-2617163
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

2000 Daniel Island Drive
Charleston, South Carolina 29492
(Address of principal executive offices, including zip code)
(843) 216-6200
(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 ý 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 (Section 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 ý 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 ý	Accelerated filer ¨
Non-accelerated filer ¨ (Do not check if a smaller reporting company)	Smaller reporting company ¨

Indicate by check mark whether registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
YES ¨ NO ý
The number of shares of the registrant's Common Stock outstanding as of October 25, 2013 was 45,786,196.

BLACKBAUD, INC.
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Safe Harbor Cautionary Statement

This Quarterly Report on Form 10-Q, including the section titled "Management's discussion and analysis of financial condition and results of operations" in Part I, Item 2, contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Forward-looking statements consist of, among other things, trend analyses, statements regarding future events, future financial performance, our anticipated growth, the effect of general economic and market conditions, our business strategy and our plan to build and grow our business, our operating results, our ability to successfully integrate acquired businesses and technologies, the effect of foreign currency exchange rate and interest rate fluctuations on our financial results, the impact of expensing stock-based compensation, the sufficiency of our capital resources, our ability to meet our ongoing debt and obligations as they become due, and potential litigation involving us, all of which are based on current expectations, estimates, and forecasts, and the beliefs and assumptions of our management. Words such as "expects," "anticipates," "aims," "projects," "intends," "plans," "likely," "will," "should," "believ "estimates," "seeks," variations of such words, and similar expressions are also intended to identify such forward-looking statements. These forward-looking statements are subject to risks, uncertainties and assumptions that are difficult to predict. Therefore, actual results may differ materially and adversely from those expressed in any forward-looking statements. Factors that could cause actual results to differ materially from our expectations expressed in the report include: general economic risks; lengthy sales and implementation cycles, particularly in larger organizations; uncertainty regarding increased business and renewals from existing customers; continued success in sales growth; management of integration of recently acquired companies and other risks associated with acquisitions; the ability to attract and retain key personnel; risks associated with successful implementation of multiple integrated software products; risks related to our dividend policy and stock repurchase program, including potential limitations on our ability to grow and the possibility that we might discontinue payment of dividends; risks relating to restrictions imposed by our credit facility; risks associated with management of growth; technological changes that make our products and services less competitive; and the other risk factors set forth from time to time in our SEC filings. Factors that could cause or contribute to such differences include, but are not limited to, those summarized under Risk Factors in our annual report on Form 10-K for the year ended December 31, 2012, and our quarterly reports on Forms 10-Q. Given these risks and uncertainties, you should not place undue reliance on these forward-looking statements. Also, forward-looking statements represent our management's beliefs and assumptions only as of the date of this quarterly report on Form 10-Q. Except as required by law, we do not intend, and undertake no obligation to revise or update these forward-looking statements, or to update the reasons actual results could differ materially from those anticipated in these forward-looking statements, even if new information becomes available in the future.

PART I- FINANCIAL INFORMATION

Item 1. Financial Statements

Blackbaud, Inc.

Consolidated balance sheets

(Unaudited)

(in thousands, except share amounts)	September 30, 2013	December 31, 2012
Assets		
Current assets:		
Cash and cash equivalents	$16,679	$13,491
Donor restricted cash	41,758	68,177
Accounts receivable, net of allowance of $6,809 and $8,546 at September 30, 2013 and December 31, 2012, respectively	71,309	75,692
Prepaid expenses and other current assets	30,286	40,589
Deferred tax asset, current portion	8,732	15,799
Total current assets	168,764	213,748
Property and equipment, net	48,413	49,063
Goodwill	264,639	265,055
Intangible assets, net	149,698	168,037
Other assets	18,435	9,844
Total assets	$649,949	$705,747
Liabilities and stockholders' equity		
Current liabilities:		
Trade accounts payable	$8,449	$13,623
Accrued expenses and other current liabilities	39,551	45,996
Donations payable	41,758	68,177
Debt, current portion	12,500	10,000
Deferred revenue, current portion	185,406	173,899
Total current liabilities	287,664	311,695
Debt, net of current portion	161,200	205,500
Deferred tax liability	29,944	24,468
Deferred revenue, net of current portion	8,619	11,119
Other liabilities	5,850	5,281
Total liabilities	493,277	558,063
Commitments and contingencies (see Note 9)		
Stockholders' equity:		
Preferred stock; 20,000,000 shares authorized, none outstanding	—	—
Common stock, $0.001 par value; 180,000,000 shares authorized, 55,222,085 and 54,859,604 shares issued at September 30, 2013 and December 31, 2012, respectively	55	55
Additional paid-in capital	216,827	203,638
Treasury stock, at cost; 9,425,277 and 9,209,371 shares at September 30, 2013 and December 31, 2012, respectively	(178,001)	(170,898)
Accumulated other comprehensive loss	(1,409)	(1,973)
Retained earnings	119,200	116,862
Total stockholders' equity	156,672	147,684
Total liabilities and stockholders' equity	$649,949	$705,747

The accompanying notes are an integral part of these consolidated financial statements.

Blackbaud, Inc.
Consolidated statements of comprehensive income
(Unaudited)

(in thousands, except share and per share amounts)	Three months ended September 30,		Nine months ended September 30,	
	2013	2012	2013	2012
Revenue				
License fees	$3,831	$4,465	$12,801	$16,154
Subscriptions	52,034	47,414	151,754	113,399
Services	35,411	34,463	95,617	90,211
Maintenance	34,722	34,499	102,992	101,945
Other revenue	1,856	1,631	5,781	5,659
Total revenue	127,854	122,472	368,945	327,368
Cost of revenue				
Cost of license fees	492	728	1,860	2,162
Cost of subscriptions	21,482	19,616	63,470	49,151
Cost of services	26,121	26,438	78,023	71,779
Cost of maintenance	6,653	6,789	19,088	18,944
Cost of other revenue	1,366	1,557	3,864	4,672
Total cost of revenue	56,114	55,128	166,305	146,708
Gross profit	71,740	67,344	202,640	180,660
Operating expenses				
Sales and marketing	23,833	26,279	72,648	70,879
Research and development	16,547	19,205	49,459	47,365
General and administrative	12,628	14,985	38,219	51,239
Restructuring	110	—	3,466	—
Amortization	614	690	1,928	1,417
Impairment of cost method investment	—	—	—	200
Total operating expenses	53,732	61,159	165,720	171,100
Income from operations	18,008	6,185	36,920	9,560
Interest income	16	38	53	118
Interest expense	(1,394)	(1,976)	(4,585)	(3,629)
Other (expense) income, net	(140)	382	(346)	(66)
Income before provision for income taxes	16,490	4,629	32,042	5,983
Income tax provision	7,097	1,804	13,360	2,670
Net income	$9,393	$2,825	$18,682	$3,313
Earnings per share				
Basic	$0.21	$0.06	$0.42	$0.08
Diluted	$0.21	$0.06	$0.41	$0.07
Common shares and equivalents outstanding				
Basic weighted average shares	44,735,425	44,172,836	44,583,623	44,077,911
Diluted weighted average shares	45,569,275	44,718,101	45,332,617	44,650,028
Dividends per share	$0.12	$0.12	$0.36	$0.36
Other comprehensive (loss) income				
Foreign currency translation adjustment	94	(123)	113	(12)
Unrealized (loss) gain on derivative instruments, net of tax	(97)	(319)	451	(883)
Total other comprehensive (loss) income	(3)	(442)	564	(895)

Comprehensive income	$9,390	$2,383	$19,246	$2,418

The accompanying notes are an integral part of these consolidated financial statements.

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Blackbaud, Inc.
Consolidated statements of cash flows
(Unaudited)

(in thousands)	Nine months ended September 30, 2013	2012
Cash flows from operating activities		
Net income	$18,682	$3,313
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	31,625	21,433
Provision for doubtful accounts and sales returns	1,072	4,212
Stock-based compensation expense	12,968	14,455
Excess tax benefits from stock-based compensation	—	(81)
Deferred taxes	9,192	2,670
Impairment of cost method investment	—	200
Other non-cash adjustments	1,390	444
Changes in operating assets and liabilities, net of acquisition of businesses:		
Accounts receivable	3,203	(11,965)
Prepaid expenses and other assets	10,092	(5,609)
Trade accounts payable	(1,466)	(1,313)
Accrued expenses and other liabilities	(18,643)	(3,618)
Donor restricted cash	26,626	14,273
Donations payable	(26,626)	(14,273)
Deferred revenue	9,855	15,528
Net cash provided by operating activities	77,970	39,669
Cash flows from investing activities		
Purchase of property and equipment	(13,407)	(15,427)
Purchase of net assets of acquired companies, net of cash acquired	(876)	(280,687)
Capitalized software development costs	(2,371)	(572)
Net cash used in investing activities	(16,654)	(296,686)
Cash flows from financing activities		
Proceeds from issuance of debt	63,100	315,000
Payments on debt	(104,900)	(70,000)
Payments of deferred financing costs	—	(2,440)
Proceeds from exercise of stock options	335	3,105
Excess tax benefits from stock-based compensation	—	81
Dividend payments to stockholders	(16,458)	(16,248)
Net cash (used in) provided by financing activities	(57,923)	229,498
Effect of exchange rate on cash and cash equivalents	(205)	581
Net increase (decrease) in cash and cash equivalents	3,188	(26,938)
Cash and cash equivalents, beginning of period	13,491	52,520
Cash and cash equivalents, end of period	$16,679	$25,582

The accompanying notes are an integral part of these consolidated financial statements.

Blackbaud, Inc.
Consolidated statements of stockholders’ equity
(Unaudited)

(in thousands, except share amounts)	Common stock		Additional paid-in capital	Treasury stock	Accumulated other comprehensive loss	Retained earnings	Total stockholders' equity
	Shares	Amount					
Balance at December 31, 2011	53,959,532	$ 54	$ 175,401	$ (166,226)	$ (1,148)	$ 131,921	$ 140,002
Net income	—	—	—	—	—	6,583	6,583
Payment of dividends	—	—	—	—	—	(21,731)	(21,731)
Exercise of stock options, stock appreciation rights and restricted stock units	355,180	—	3,146	—	—	—	3,146
Surrender of 189,547 shares upon restricted stock and restricted stock unit vesting and exercise of stock appreciation rights	—	—	—	(4,672)	—	—	(4,672)
Tax impact of exercise of equity-based compensation	—	—	81	—	—	—	81
Stock-based compensation	—	—	19,151	—	—	89	19,240
Equity-based awards assumed in business combination	—	—	5,859	—	—	—	5,859
Restricted stock grants	687,652	1	—	—	—	—	1
Restricted stock cancellations	(142,760)	—	—	—	—	—	—
Other comprehensive loss	—	—	—	—	(825)	—	(825)
Balance at December 31, 2012	54,859,604	$ 55	$ 203,638	$ (170,898)	$ (1,973)	$ 116,862	$ 147,684
Net income	—	—	—	—	—	18,682	18,682
Payment of dividends	—	—	—	—	—	(16,458)	(16,458)
Exercise of stock options, stock appreciation rights and restricted stock units	496,615	—	335	—	—	—	335
Surrender of 215,906 shares upon restricted stock and restricted stock unit vesting and exercise of stock appreciation rights	—	—	—	(7,103)	—	—	(7,103)
Stock-based compensation	—	—	12,854	—	—	114	12,968
Restricted stock grants	53,543	—	—	—	—	—	—
Restricted stock cancellations	(187,677)	—	—	—	—	—	—
Other comprehensive income	—	—	—	—	564	—	564
Balance at September 30, 2013	55,222,085	$ 55	$ 216,827	$ (178,001)	$ (1,409)	$ 119,200	$ 156,672

The accompanying notes are an integral part of these consolidated financial statements.

Blackbaud, Inc.
Notes to consolidated financial statements
(Unaudited)

1. Organization

We provide cloud-based and on-premise software solutions and related services designed specifically for nonprofit organizations. Our products and services enable nonprofit organizations to increase donations, reduce fundraising costs, improve communications with constituents, manage their finances and optimize internal operations. As of September 30, 2013, we had over 29,000 active customers distributed across multiple verticals within the nonprofit market including education, foundations, health and human services, religion, arts and cultural, public and societal benefits, environment and animal welfare, as well as international foreign affairs.

2. Summary of significant accounting policies

Unaudited interim consolidated financial statements

The accompanying interim consolidated financial statements have been prepared pursuant to the rules and regulations of the United States Securities and Exchange Commission (SEC) for interim financial reporting. These consolidated statements are unaudited and, in the opinion of management, include all adjustments (consisting of normal recurring adjustments and accruals) necessary to state fairly the consolidated balance sheets, consolidated statements of comprehensive income, consolidated statements of cash flows and consolidated statements of stockholders' equity, for the periods presented in accordance with accounting principles generally accepted in the United States (GAAP). The consolidated balance sheet at December 31, 2012, has been derived from the audited consolidated financial statements at that date. Operating results for the three and nine months ended September 30, 2013 and cash flows for the nine months ended September 30, 2013 are not necessarily indicative of the results that may be expected for the fiscal year ending December 31, 2013, or any other future period. Certain information and footnote disclosures normally included in annual financial statements prepared in accordance with GAAP have been omitted in accordance with the rules and regulations for interim reporting of the SEC. These interim consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2012, and other forms filed with the SEC from time to time.

Basis of consolidation

The consolidated financial statements include the accounts of Blackbaud, Inc. and its wholly-owned subsidiaries. All significant intercompany balances and transactions have been eliminated in consolidation.

Use of estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions. These estimates and assumptions affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, as well as the reported amounts of revenues and expenses during the reporting periods. On an ongoing basis, we reconsider and evaluate our estimates and assumptions, including those that impact revenue recognition, long-lived and intangible assets and goodwill, stock-based compensation, the provision for income taxes, capitalization of software development costs, our allowance for sales returns and doubtful accounts, deferred sales commissions, accounting for business combinations and loss contingencies. Changes in the facts or circumstances underlying these estimates could result in material changes and actual results could materially differ from these estimates.

Revenue recognition

Our revenue is primarily generated from the following sources: (i) charging for the use of our software products in a hosted environment; (ii) selling perpetual licenses of our software products; (iii) providing professional services including implementation, training, consulting, analytic, hosting and other services; and (iv) providing software maintenance and support services.

We recognize revenue when all of the following conditions are met:

- Persuasive evidence of an arrangement exists;

•The product or services have been delivered;

Blackbaud, Inc.
Notes to consolidated financial statements
(Unaudited)

•The fee is fixed or determinable; and
•Collection of the resulting receivable is probable.

Determining whether and when these criteria have been met can require significant judgment and estimates. We deem acceptance of an agreement to be evidence of an arrangement. Delivery of our services occurs when the services have been performed. Delivery of our products occurs when the product is shipped or transmitted, and title and risk of loss have transferred to the customers. Our typical agreements do not include customer acceptance provisions; however, if acceptance provisions are provided, delivery is deemed to occur upon acceptance. We consider the fee to be fixed or determinable unless the fee is subject to refund or adjustment or is not payable within our standard payment terms. Payment terms greater than 90 days are considered to be beyond our customary payment terms. Collection is deemed probable if we expect that the customer will be able to pay amounts under the arrangement as they become due. If we determine that collection is not probable, we defer revenue recognition until collection. Revenue is recognized net of sales returns and allowances.

We follow guidance provided in ASC 605-45, Principal Agent Considerations, which states that determining whether a company should recognize revenue based on the gross amount billed to a customer or the net amount retained is a matter of judgment that depends on the facts and circumstances of the arrangement and that certain factors should be considered in the evaluation.

Subscriptions

We provide hosting services to customers who have purchased perpetual rights to certain of our software products (hosting services). Revenue from hosting services, as well as data enrichment services, data management services and online training programs, is recognized ratably beginning on the activation date over the term of the agreement, which generally ranges from one to three years. Any related set-up fees are recognized ratably over the estimated period that the customer benefits from the related hosting service.

We make certain of our software products available for use in hosted application arrangements without licensing perpetual rights to the software (hosted applications). Revenue from hosted applications is recognized ratably beginning on the activation date over the term of the agreement, which generally ranges from one to three years. Any revenue related to upfront activation, set-up or implementation fees is recognized ratably over the estimated period that the customer benefits from the related hosted application. Direct and incremental costs relating to activation, set-up and implementation for hosted applications are capitalized until the hosted application is deployed and in use, and then expensed over the estimated period that the customer benefits from the related hosted application.

For arrangements that have multiple elements and do not include software licenses, we allocate arrangement consideration at the inception of the arrangement to those elements that qualify as separate units of accounting. The arrangement consideration is allocated to the separate units of accounting based on relative selling price method in accordance with the selling price hierarchy, which includes: (i) vendor specific objective evidence (VSOE) if available; (ii) third-party evidence (TPE) if VSOE is not available; and (iii) best estimate of selling price (BESP) if neither VSOE nor TPE is available. In general, we use VSOE to allocate the selling price to subscription and service deliverables.

We offer certain payment processing services with the assistance of third-party vendors. When we are the primary obligor in a transaction, have latitude in establishing prices and are the party determining the service specifications or have several but not all of these indicators, we record the revenue on a gross basis. Otherwise, we record revenue associated with the related subscribers on a net basis, netting the cost of revenue associated with the service against the gross amount billed the customer and record the net amount as revenue.

Revenue from transaction processing fees is recognized when the service is provided and the amounts are determinable. Revenue directly associated with processing donations for customers are included in subscriptions revenue, net of related transaction costs.

License fees

We sell software licenses with maintenance, varying levels of professional services and, in certain instances, with hosting services. We allocate revenue to each of the elements in these arrangements using the residual method under which we first allocate revenue to the undelivered elements, typically the non-software license components, based on objective evidence of the

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Blackbaud, Inc.
Notes to consolidated financial statements
(Unaudited)

fair value of the various elements. We determine the fair value of the various elements using different methods. Fair value for maintenance services associated with software licenses is based upon renewal rates stated in the agreements with customers, which vary according to the level of support service provided under the maintenance program. Fair value of professional services and other products and services is based on sales of these products and services to other customers when sold on a stand-alone basis. Any remaining revenue is allocated to the delivered elements which is normally the software license in the arrangement.

When a software license is sold with software customization services, generally the services are to provide customer support for assistance in creating special reports and other enhancements that will assist with efforts to improve operational efficiency and/or to support business process improvements. These services are generally not essential to the functionality of the software. However, when software customization services are considered essential to the functionality of the software, we recognize revenue for both the software license and the services using the percentage-of-completion method.

Services

We generally bill consulting, installation and implementation services based on hourly rates plus reimbursable travel-related expenses. Revenue is recognized for these services over the period the services are performed.

We recognize analytic services revenue from donor prospect research engagements, the sale of lists of potential donors, benchmarking studies and data modeling service engagements upon delivery. In arrangements where we provide customers the right to updates to the lists during the contract period, revenue is recognized ratably over the contract period.

We sell training at a fixed rate for each specific class at a per attendee price or at a packaged price for several attendees, and recognize the related revenue upon the customer attending and completing training. Additionally, we sell fixed-rate programs, which permit customers to attend unlimited training over a specified contract period, typically one year, subject to certain restrictions, and revenue is recognized ratably over the contract period.

Maintenance

We recognize revenue from maintenance services ratably over the contract term, typically one year. Maintenance contracts are at rates that vary according to the level of the maintenance program and are generally renewable annually. Maintenance contracts also include the right to unspecified product upgrades on an if-and-when available basis. Certain support services are sold in prepaid units of time and recognized as revenue upon their usage.

Deferred revenue

To the extent that our customers are billed for the above described services in advance of delivery, we record such amounts in deferred revenue.

Goodwill

The change in goodwill for each reportable segment during the nine months ended September 30, 2013, consisted of the following:

(in thousands)	ECBU	GMBU	IBU	Target Analytics	Other	Total
Balance at December 31, 2012	$148,322	$75,149	$6,311	$33,177	$2,096	$265,055
Additions related to business combinations	—	—	413	—	—	413
Adjustments related to prior year business combinations	(494)	(193)	—	—	—	(687)
Effect of foreign currency translation	—	—	(142)	—	—	(142)
Balance at September 30, 2013	$147,828	$74,956	$6,582	$33,177	$2,096	$264,639

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Blackbaud, Inc.
Notes to consolidated financial statements
(Unaudited)

Amortization expense

Amortization expense related to finite-lived intangible assets acquired in business combinations is allocated to cost of revenue and operating expenses on the consolidated statements of comprehensive income based on the revenue stream to which the asset contributes. The following table summarizes amortization expense:

	Three months ended September 30,		Nine months ended September 30,	
(in thousands)	2013	2012	2013	2012
Included in cost of revenue:				
Cost of license fees	$87	$119	$334	$366
Cost of subscriptions	4,657	4,044	13,968	7,732
Cost of services	631	571	1,897	1,450
Cost of maintenance	114	114	342	608
Cost of other revenue	19	18	57	56
Total included in cost of revenue	5,508	4,866	16,598	10,212
Included in operating expenses	614	690	1,928	1,417
Total	$6,122	$5,556	$18,526	$11,629

The following table outlines the estimated future amortization expense for each of the next five years for our finite-lived intangible assets as of September 30, 2013:

Year ending December 31, (in thousands)	Amortization expense
2013 - remaining	$6,074
2014	22,601
2015	22,227
2016	21,819
2017	19,501
Total	$92,222

Recently adopted accounting pronouncements

Effective January 1, 2013, we adopted ASU 2013-02, Comprehensive Income (Topic 220), Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income, which requires that entities provide information about the amounts reclassified out of accumulated other comprehensive income by component. In addition, entities are required to present, either on the face of the statement where net income is presented or in the notes, significant amounts reclassified out of accumulated other comprehensive income by the respective line items of net income but only if the amount reclassified is required under GAAP to be reclassified to net income in its entirety in the same reporting period. For other amounts that are not required under GAAP to be reclassified in their entirety to net income, entities are required to cross-reference to other disclosures required under GAAP that provide additional detail about those amounts. The adoption of ASU 2013-02 did not have a material impact on our consolidated financial statements. We have presented the amounts reclassified out of accumulated other comprehensive income by component in Note 8 and Note 12 to our consolidated financial statements.

Effective January 1, 2013, we adopted ASU 2012-02, Intangibles - Goodwill and Other (Topic 350), Testing Indefinite-Lived Intangible Assets for Impairment, which simplifies how entities test indefinite-lived intangible assets for impairment. ASU 2012-02 permits an entity to first assess qualitative factors to determine whether it is more likely than not that an indefinite-lived intangible asset is impaired as a basis for determining whether it is necessary to

perform the quantitative impairment test currently required by ASC Topic 350-30 on general intangibles other than goodwill. The adoption of ASU 2012-02 did not have a material impact on our consolidated financial statements.

Blackbaud, Inc.
Notes to consolidated financial statements
(Unaudited)

Recently issued accounting pronouncements

In July 2013, the FASB issued ASU 2013-11, Income Taxes (Topic 740), Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists. Under ASU 2013-11, an unrecognized tax benefit, or a portion of an unrecognized tax benefit, should be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward or a similar tax loss, or a tax credit carryforward, except as follows. To the extent a net operating loss carryforward, a similar tax loss, or a tax credit carryforward is not available at the reporting date under the tax law of the applicable jurisdiction to settle any additional income taxes that would result from the disallowance of a tax position or the tax law of the applicable jurisdiction does not require the entity to use, and the entity does not intend to use, the deferred tax asset for such purpose, the unrecognized tax benefit should be presented in the financial statements as a liability and should not be combined with deferred tax assets. ASU 2013-11 is effective for fiscal years and interim periods within those years, beginning after December 15, 2013. Early adoption is permitted. We do not anticipate any material impact from the adoption of ASU 2013-11.

3. Business combinations

Convio

In May 2012, we completed our acquisition of Convio, Inc. (Convio), for approximately $329.8 million in cash consideration and the assumption of unvested equity awards valued at approximately $5.9 million, for a total of $335.7 million. Convio was a leading provider of on-demand constituent engagement solutions that enabled nonprofit organizations to more effectively raise funds, advocate for change and cultivate relationships. The acquisition of Convio expands our subscription and online offerings and accelerates our evolution to a subscription-based revenue model. As a result of the acquisition, Convio has become a wholly-owned subsidiary of ours. The results of operations of Convio are included in our consolidated financial statements from the date of acquisition. Because we have integrated a substantial amount of the Convio operations and have made product rationalization decisions, it is not possible to determine the revenue and operating costs attributable solely to the acquired business. During the year ended December 31, 2012, we incurred $6.4 million of acquisition-related costs associated with the acquisition of Convio, which were recorded in general and administrative expense.

We financed the acquisition of Convio through cash on hand and borrowings of $312.0 million under our credit facility. In connection with closing the Convio acquisition, we designated Convio as a material domestic subsidiary under our credit facility. As a material domestic subsidiary, Convio guarantees amounts outstanding under the credit facility and pledges certain stock of its subsidiaries.

The following table summarizes the allocation of the purchase price based on the estimated fair value of the assets acquired and the liabilities assumed:

(in thousands)	
Net working capital, excluding deferred revenue	$57,062
Property and equipment	6,591
Other long term assets	75
Deferred revenue	(7,847)
Deferred tax liability	(33,181)
Intangible assets and liabilities	139,650
Goodwill	173,324
	$335,674

The estimated fair value of accounts receivable acquired approximates the contractual value of $12.8 million. The goodwill recognized was attributable primarily to the assembled workforce of Convio and the opportunities for

expected synergies. None of the goodwill arising in the acquisition is deductible for income tax purposes. The estimated amount of goodwill assigned to the Enterprise Customer Business Unit and the General Markets Business Unit reporting segments was $124.8 million, and $48.5 million, respectively.

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The acquisition resulted in the identification of the following identifiable intangible assets:

	Intangible assets acquired	Weighted average amortization period
	(in thousands)	(in years)
Customer relationships	$53,000	15
Marketing assets	7,800	7
Acquired technology	69,000	8
In-process research and development	9,100	7
Non-compete agreements	1,440	2
Unfavorable leasehold interests	(690)	7
	$139,650	

The fair value of the intangible assets was based on the income approach, cost approach, relief of royalty rate method and excess earnings methods. Customer relationships are amortized on an accelerated basis. Marketing assets, acquired technology and non-compete agreements are amortized on a straight-line basis. In-process research and development was placed into service subsequent to the time of acquisition and is amortized on a straight-line basis from the time of being placed into service over a weighted average amortization period of seven years.

The following unaudited pro forma condensed consolidated results of operations assume that the acquisition of Convio occurred on January 1, 2012. This unaudited pro forma financial information does not reflect any adjustments for anticipated synergies resulting from the acquisition and should not be relied upon as being indicative of the historical results that would have been attained had the transaction been consummated as of January 1, 2012, or of the results that may occur in the future.

	Three months ended September 30,		Nine months ended September 30,	
(in thousands, except per share amounts)	2013	2012	2013	2012
Revenue	$127,854	$122,472	$368,945	$356,836
Net income (loss)	$9,393	$2,825	$18,682	$(3,154)
Basic earnings (loss) per share	$0.21	$0.06	$0.42	$(0.07)
Diluted earnings (loss) per share	$0.21	$0.06	$0.41	$(0.07)

4. Earnings per share

We compute basic earnings per share by dividing net income available to common stockholders by the weighted average number of common shares outstanding during the period. Diluted earnings per share is computed by dividing net income available to common stockholders by the weighted average number of common shares and dilutive potential common shares outstanding during the period. Diluted earnings per share reflect the assumed conversion of all dilutive securities using the treasury stock method. Dilutive potential common shares consist of shares issuable upon the exercise of stock options, settlement of stock appreciation rights and vesting of restricted stock awards and units.

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The following table sets forth the computation of basic and diluted earnings per share:

(in thousands, except share and per share amounts)	Three months ended September 30, 2013	2012	Nine months ended September 30, 2013	2012
Numerator:				
Net income, as reported	$9,393	$2,825	$18,682	$3,313
Denominator:				
Weighted average common shares	44,735,425	44,172,836	44,583,623	44,077,911
Add effect of dilutive securities:				
Employee equity-based compensation	833,850	545,265	748,994	572,117
Weighted average common shares assuming dilution	45,569,275	44,718,101	45,332,617	44,650,028
Earnings per share:				
Basic	$0.21	$0.06	$0.42	$0.08
Diluted	$0.21	$0.06	$0.41	$0.07

The following shares and potential shares underlying stock-based awards were not included in diluted earnings per share because their inclusion would have been anti-dilutive:

	Three months ended September 30, 2013	2012	Nine months ended September 30, 2013	2012
Shares excluded from calculations of diluted earnings per share	44,728	604,243	56,604	121,488

5. Prepaid expenses and other assets

Prepaid expenses and other assets consisted of the following as of:

(in thousands)	September 30, 2013	December 31, 2012
Deferred sales commissions	$19,116	$18,142
Prepaid software maintenance	6,603	5,530
Taxes, prepaid and receivable	821	7,398
Deferred professional services costs	7,759	8,057
Other assets	14,422	11,306
Total prepaid expenses and other assets	48,721	50,433
Less: Long-term portion	18,435	9,844
Total prepaid expenses and other current assets	$30,286	$40,589

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6. Accrued expenses and other liabilities

Accrued expenses and other liabilities consisted of the following as of:

(in thousands)	September 30, 2013	December 31, 2012
Taxes payable	$5,433	$7,607
Accrued commissions and salaries	6,776	5,905
Accrued bonuses	7,835	11,966
Customer credit balances	2,503	4,577
Accrued software and maintenance	2,031	3,875
Unrecognized tax benefit	3,970	3,846
Other liabilities	16,853	13,501
Total accrued expenses and other liabilities	45,401	51,277
Less: Long-term portion	5,850	5,281
Total accrued expenses and other current liabilities	$39,551	$45,996

7. Debt

Credit facility

We have a five-year $325.0 million credit facility which includes the following facilities: (i) a dollar and a designated currency revolving credit facility with sublimits for letters of credit and swingline loans, and (ii) a delayed draw term loan. The credit facility is secured by the stock and limited liability company interests of certain of our subsidiaries and is guaranteed by our material domestic subsidiaries.

Amounts borrowed under the dollar tranche revolving credit loans and delayed draw term loans under the credit facility bear interest at a rate per annum equal to, at our option, (a) Base Rate equal to the highest of (i) the prime rate, (ii) federal funds rate plus 0.50% and (iii) one month LIBOR plus 1%, in addition to a margin of 0.25% to 1.25%, or (b) LIBOR rate plus a margin of 1.25% to 2.25%. Swingline loans bear interest at a rate per annum equal to the Base Rate plus a margin of 0.25% to 1.25% or such other rate agreed to between the Swingline lender and us. Designated currency tranche revolving credit loans bear interest at a rate per annum equal to the LIBOR rate for the applicable currency plus a margin of 1.25% to 2.25%. The exact amount of any margin depends on the nature of the loan and our leverage ratio.

We also pay a quarterly commitment fee on the unused portion of the revolving credit facility from 0.20% to 0.35% per annum, depending on our leverage ratio. At September 30, 2013, the commitment fee was 0.28%.

The term loans under our credit facility require periodic principal payments. The balance of the term loans and any amounts drawn on the revolving credit loans are due upon maturity of the credit facility in February 2017. We evaluate the classification of our debt based on the required annual maturities of our credit facility.

The credit facility includes financial covenants related to the leverage ratio and interest ratio, as well as restrictions on the maximum amount of annual capital expenditures, our ability to declare and pay dividends and our ability to repurchase shares of our common stock. At September 30, 2013, we were in compliance with our debt covenants under the credit facility.

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The following table summarizes our debt balances and the related effective interest rate which includes our interest cost incurred and the effect of interest rate swap agreements.

(in thousands, except percentages)	Debt balance at September 30, 2013	December 31, 2012	Effective interest rate at September 30, 2013	December 31, 2012
Credit facility:				
Revolving credit loans	$88,700	$123,000	2.29 %	2.68 %
Term loans	85,000	92,500	2.64 %	3.14 %
Total debt	173,700	215,500	2.46 %	2.88 %
Less: Debt, current portion	12,500	10,000	2.64 %	3.14 %
Debt, net of current portion	$161,200	$205,500	2.45 %	2.86 %

We believe the carrying amount of our credit facility approximates its fair value at September 30, 2013 and December 31, 2012, due to the variable rate nature of the debt. As LIBOR rates are observable at commonly quoted intervals, it is classified within Level 2 of the fair value hierarchy.

As of September 30, 2013, the required annual maturities related to our credit facility were as follows:

Year ending December 31, (in thousands)	Annual maturities
2013 - remaining	$2,500
2014	13,750
2015	15,000
2016	15,000
2017	127,450
Total required maturities	$173,700

Deferred financing costs

In February 2012, we amended and restated our credit facility to increase our borrowing capacity. In connection with our amended and restated credit facility we paid $2.4 million of financing costs. These costs together with a portion of the unamortized financing costs from our previous credit facility are being amortized over the term of the new facility. As of September 30, 2013 and December 31, 2012, deferred financing costs totaling $2.1 million and $2.5 million, respectively, are included in other assets on the consolidated balance sheet.

8. Derivative instruments

We use derivative instruments to manage interest rate risk. We have two interest rate swap agreements which effectively convert portions of our variable rate debt under our credit facility to a fixed rate for the terms of the swap agreements. The aggregate notional value of the swap agreements was $150.0 million with effective dates beginning in May 2012 through January 2017. We designated the swap agreements as cash flow hedges at the inception of the contracts.

The fair values of our derivative instruments were as follows as of:

(in thousands)	Balance sheet location	Liability fair value at September 30, 2013	December 31, 2012
Derivative instruments designated as hedging instruments:			
Interest rate swaps, current portion	Accrued expenses and other current liabilities	$85	$—
Interest rate swaps, long-term portion	Other liabilities	472	1,296

Total derivative instruments designated as hedging instruments	$557	$1,296

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The fair value of our interest rate swaps was based on model-driven valuations using LIBOR rates, which are observable at commonly quoted intervals. Accordingly, our interest rate swaps are classified within Level 2 of the fair value hierarchy.

The effects of derivative instruments in cash flow hedging relationships were as follows:

(in thousands)	Loss recognized in accumulated other comprehensive loss as of September 30, 2013	Location of loss reclassified from accumulated other comprehensive loss into income	Amount reclassified from accumulated other comprehensive loss into income: Three months ended September 30, 2013	Nine months ended September 30, 2013
Interest rate swaps	$557	Interest expense	$203	$592
	September 30, 2012		Three months ended September 30, 2012	Nine months ended September 30, 2012
Interest rate swaps	$1,447	Interest expense	$194	$258

We recognize income tax expense or benefit within accumulated other comprehensive loss each reporting period based on the change in fair value of our derivative instruments. The income tax benefit recognized in accumulated other comprehensive loss was $0.1 million for the three months ended September 30, 2013. The income tax benefit recognized in accumulated other comprehensive loss decreased $0.3 million during the nine months ended September 30, 2013. The income tax benefit recognized in accumulated other comprehensive loss was $0.2 million and $0.6 million for the three and nine months ended September 30, 2012, respectfully. There was no ineffective portion of our interest rate swaps during the three and nine months ended September 30, 2013 and 2012.

9. Commitments and contingencies

Leases

We lease our headquarters facility under a 15-year lease agreement which was entered into in October 2008, and has two five-year renewal options. The current annual base rent of the lease is $4.0 million payable in equal monthly installments. The base rent escalates annually at a rate equal to the change in the consumer price index, as defined in the agreement, but not to exceed 5.5% in any year.

With our acquisition of Convio, we assumed a lease for office space in Austin, Texas which terminates on September 30, 2023, and has two five-year renewal options. Under the terms of the lease, we will increase our leased space by approximately 20,000 square feet on July 31, 2016. The current annual base rent of the lease is $2.2 million. The terms of the agreement include a rent holiday during the first year and base rent that escalates annually thereafter between 2% and 4%. The related rent expense is recorded on a straight-line basis over the length of the lease term. We have a standby letter of credit of $2.0 million for a security deposit for this lease.

We have provisions in our leases that entitle us to aggregate leasehold improvement allowances of $9.5 million. These amounts will be recorded as a reduction to rent expense ratably over the terms of the leases. Rent expense was reduced related to these lease provisions by $0.1 million and $0.4 million, during the three and nine months ended September 30, 2013, respectively, and by $0.1 million and $0.2 million during the three and nine months ended September 30, 2012, respectively. The leasehold improvement allowances have been included in the table of operating lease commitments below as a reduction in our lease commitments ratably over the then remaining terms of the leases.

The timing of the reimbursements for the actual leasehold improvements may vary from the amounts reflected in the table below.

Additionally, we have subleased portions of our facilities under various agreements extending through 2013. The reduction in rent expense related to these agreements during the three and nine months ended September 30, 2013 was not material to the consolidated statements of comprehensive income. Rent expense was reduced by $0.1 million and $0.3 million related to these agreements during the three and nine months ended September 30, 2012, respectively.

We have also received, and expect to receive through 2016, quarterly South Carolina state incentive payments as a result of locating our headquarters facility in Berkeley County, South Carolina. These amounts are recorded as a reduction of rent expense and were $0.6 million and $0.4 million for the three months ended September 30, 2013 and 2012, respectively and $1.6 million and $1.6 million for the nine months ended September 30, 2013 and 2012, respectively. Total rent expense was

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$2.2 million and $2.3 million for the three months ended September 30, 2013 and 2012, respectively and $6.7 million and $5.4 million for the nine months ended September 30, 2013 and 2012, respectively.

Additionally, we lease various office space and equipment under operating leases. We also have various non-cancelable capital leases for computer equipment and furniture that are not significant.

As of September 30, 2013, the future minimum lease commitments related to lease agreements, net of related sublease commitments and lease incentives, were as follows:

Year ending December 31, (in thousands)	Operating leases
2013 – remaining	$2,355
2014	10,038
2015	9,875
2016	9,556
2017	9,596
Thereafter	51,183
Total minimum lease payments	$92,603

Other commitments

We utilize third-party relationships in conjunction with our products and services, with contractual arrangements varying in length from one to three years. In certain cases, these arrangements require a minimum annual purchase commitment. As of September 30, 2013, the remaining aggregate minimum purchase commitment under these arrangements was approximately $13.9 million through 2016. We incurred expense under these arrangements of $1.4 million and $2.1 million for the three and nine months ended September 30, 2013.

Legal contingencies

We are subject to legal proceedings and claims that arise in the ordinary course of business. We record an accrual for a contingency when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated. We do not believe the amount of potential liability with respect to these actions will have a material adverse effect upon our consolidated financial position, results of operations or cash flows.

10. Income taxes

Our effective tax rates including the effects of period-specific events, were:

	Three months ended September 30,		Nine months ended September 30,	
	2013	2012	2013	2012
Effective tax rate	43.0 %	39.0 %	41.7 %	44.6 %

The increase in the effective tax rate during the three months ended September 30, 2013 when compared to the same period in 2012 was due to an increase in nondeductible compensation of certain executive officers, a reduction in the 2012 benefit from research and development credits, and an increase in the proportional earnings during the three months ended September 30, 2013 as compared to the same period in 2012 relative to the estimated full year earnings for the respective periods.

The decrease in the effective tax rate during the nine months ended September 30, 2013 when compared to the same period in 2012 was primarily due to an increase in the benefit from research and development credits and a decrease in nondeductible acquisition costs, partially offset by an increase in nondeductible compensation of certain executive officers and an increase in pretax income. The research and development credits were reinstated in January 2013 with retrospective application to the 2012 tax year. The provision for income taxes differs from the tax computed at the U.S. federal statutory income tax rate of 35.0% due primarily to research and development tax credits, which were partially offset by foreign loss jurisdictions where we have

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determined a valuation allowance is appropriate, as well as state taxes. Our effective income tax rate may fluctuate quarterly as a result of factors, including transactions entered into, changes in the geographic distribution of our earnings or losses, our assessment of certain tax contingencies, valuation allowances, and changes in tax law in jurisdictions where we conduct business.

We have deferred tax assets for federal, state, and international net operating loss carryforwards and state tax credits. The federal and state net operating loss carryforwards are subject to various Internal Revenue Code limitations and applicable state tax laws. The foreign net operating loss carryforwards, a portion of the state net operating loss carryforwards and a portion of state tax credits have a valuation reserve due to the uncertainty of realizing such carryforwards and credits in the future.

The total amount of unrecognized tax benefit that, if recognized, would favorably affect the effective tax rate, was $4.0 million at September 30, 2013 and $3.8 million at December 31, 2012.

11. Stock-based compensation

Stock-based compensation expense is allocated to cost of revenue and operating expenses on the consolidated statements of comprehensive income based on the revenue stream to which the employee contributes. The following table summarizes stock-based compensation expense:

	Three months ended September 30,		Nine months ended September 30,	
(in thousands)	2013	2012	2013	2012
Included in cost of revenue:				
Cost of subscriptions	$340	$308	$755	$734
Cost of services	468	854	1,905	1,911
Cost of maintenance	100	101	356	301
Total included in cost of revenue	908	1,263	3,016	2,946
Included in operating expenses:				
Sales and marketing	512	714	1,755	1,734
Research and development	762	980	2,977	2,478
General and administrative	890	1,874	5,220	7,297
Total included in operating expenses	2,164	3,568	9,952	11,509
Total	$3,072	$4,831	$12,968	$14,455

12. Stockholders' equity

Dividends

In February 2013, our Board of Directors approved an annual dividend of $0.48 per share. The following table provides information with respect to quarterly dividends paid on common stock during the nine months ended September 30, 2013.

Declaration Date	Dividend per Share	Record Date	Payable Date
February 2013	$0.12	February 28	March 15
May 2013	$0.12	May 28	June 14
August 2013	$0.12	August 28	September 13

In November 2013, our Board of Directors declared a fourth quarter dividend of $0.12 per share payable on December 13, 2013, to stockholders of record on November 27, 2013.

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Changes in accumulated other comprehensive loss by component
The changes in accumulated other comprehensive loss by component, consisted of the following:

(in thousands)	Gains and losses on cash flow hedges	Foreign currency translation adjustment	Total
Balance at December 31, 2012	$(791)	$(1,182)	$(1,973)
Other comprehensive (loss) income before reclassifications	(141)	113	(28)
Amounts reclassified from accumulated other comprehensive loss to interest expense	592	—	592
Net current-period other comprehensive income	451	113	564
Balance at September 30, 2013	$(340)	$(1,069)	$(1,409)

13. Segment information
As of September 30, 2013, our reportable segments were the Enterprise Customer Business Unit, or the ECBU, the General Markets Business Unit, or the GMBU, the International Business Unit, or the IBU, and Target Analytics. Following is a description of each reportable segment:

- The ECBU is focused on marketing, sales, delivery and support to large and/or strategic customers, specifically identified prospects and customers in North America;
- The GMBU is focused on marketing, sales, delivery and support to all emerging and mid-sized prospects and customers in North America;
- The IBU is focused on marketing, sales, delivery and support to all prospects and customers outside of North America; and
- Target Analytics is primarily focused on marketing, sales and delivery of analytic services to all prospects and customers in North America.

Our chief operating decision maker is our chief executive officer, or CEO. The CEO reviews financial information presented on an operating segment basis for the purposes of making certain operating decisions and assessing financial performance. The CEO uses internal financial reports that provide segment revenues and operating income, excluding stock-based compensation expense, amortization expense, depreciation expense, research and development expense and certain corporate sales, marketing, general and administrative expenses. Currently, the CEO believes that the exclusion of these costs allows for a better understanding of the operating performance of the operating units and management of other operating expenses and cash needs. The CEO does not review any segment balance sheet information.

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We have recast our segment disclosures for the three and nine months ended September 30, 2012, to present them on a consistent basis with the current year. During 2013, we changed our methodology for allocating revenue and expenses to our reportable segments to provide further precision in those allocations. Summarized reportable segment financial results, were as follows:

	Three months ended September 30,		Nine months ended September 30,	
(in thousands)	2013	2012	2013	2012
Revenue by segment:				
ECBU	$49,287	$46,188	$143,241	$121,678
GMBU	55,753	54,664	164,695	148,198
IBU	10,781	10,586	30,807	29,587
Target Analytics	12,033	11,034	30,165	27,901
Other[1]	—	—	37	4
Total revenue	$127,854	$122,472	$368,945	$327,368
Segment operating income[2]:				
ECBU	$26,685	$21,417	$76,823	$53,212
GMBU	32,985	32,993	98,532	88,858
IBU	2,904	1,555	6,142	3,698
Target Analytics	6,311	6,087	13,222	13,040
Other[1]	46	60	336	345
	68,931	62,112	195,055	159,153
Less:				
Corporate unallocated costs[3]	41,729	45,540	126,641	123,509
Stock-based compensation costs	3,072	4,831	12,968	14,455
Amortization expense	6,122	5,556	18,526	11,629
Interest expense, net	1,378	1,938	4,532	3,511
Other expense (income), net	140	(382)	346	66
Income before provision for income taxes	$16,490	$4,629	$32,042	$5,983

(1) Other includes revenue and the related costs from the sale of products and services not directly attributable to an operating segment.

(2) Segment operating income includes direct, controllable costs related to the sale of products and services by the reportable segment, except for IBU, which includes operating costs from our foreign locations such as sales, marketing, general, administrative, depreciation and facilities costs.

(3) Corporate unallocated costs includes research and development, depreciation expense, and certain corporate sales, marketing, general and administrative expenses.

14. Restructuring

During 2012, in an effort to consolidate our operating locations, we decided not to renew our lease for office space in San Diego, CA, which matured on June 30, 2013. As a result, we initiated a plan to transition most of our operations based in San Diego, CA to our Austin, TX location, which we substantially completed in June 2013 when the lease matured.

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The following table summarizes our restructuring costs related to our San Diego office transition as of September 30, 2013:

(in thousands)	Total costs expected to be incurred	Costs incurred during the three months ended September 30, 2013	Costs incurred during the nine months ended September 30, 2013	Cumulative costs incurred as of September 30, 2013
By component:				
Employee severance and retention costs	$295	$—	$120	$295
Employee relocation costs	159	83	159	159
	454	83	279	454
By reportable segment:				
Other	$454	$83	$279	$454

The change in our liability related to our San Diego office transition during the nine months ended September 30, 2013, consisted of the following:

(in thousands)	Accrued at December 31, 2012	Increases for incurred costs	Costs paid	Accrued at September 30, 2013
Employee severance and retention costs	$175	$120	$(295)	$—
Employee relocation costs	—	159	(159)	—
	$175	$279	$(454)	$—

In January 2013, we implemented a realignment of our workforce in response to changes in the nonprofit industry and global economy. The realignment included a reduction in workforce of approximately 135 positions. The cost associated with this realignment was substantially incurred during the first nine months of 2013.

The following table summarizes our restructuring costs related to the reduction in workforce as of September 30, 2013:

(in thousands)	Total costs expected to be incurred	Costs incurred during the three months ended September 30, 2013	Costs incurred during the nine months ended September 30, 2013	Cumulative costs incurred as of September 30, 2013
By component:				
Employee severance costs	$3,187	$27	$3,187	$3,187
By reportable segment:				
ECBU	$828	$—	$828	$828
GMBU	290	—	290	290
Target Analytics	136	—	136	136
Other	1,933	27	1,933	1,933
	$3,187	$27	$3,187	$3,187

The change in our liability related to the reduction in workforce during the nine months ended September 30, 2013, consisted of the following:

(in thousands)	Accrued at December 31, 2012	Increases for incurred costs	Costs paid	Accrued at September 30, 2013
Employee severance costs	$—	$3,187	$(3,187)	$—

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Blackbaud, Inc.
Item 2. Management’s discussion and analysis of financial condition and results of operations

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our consolidated financial statements and related notes included elsewhere in this Quarterly Report on Form 10-Q. This report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended and Section 21E of the Securities Exchange Act of 1934, as amended. These forward-looking statements reflect our current view with respect to future events and financial performance and are subject to risks and uncertainties, including those set forth under “Safe Harbor Cautionary Statement” at the beginning of this report and elsewhere in this report, that could cause actual results to differ materially from historical or anticipated results. Except as required by law, we do not intend, and undertake no obligation to revise or update these forward-looking statements, or to update the reasons actual results could differ materially from those anticipated in these forward-looking statements, even if new information becomes available in the future.

Executive summary

We provide cloud-based and on-premise software solutions and related services designed specifically for nonprofit organizations. Our products and services enable nonprofit organizations to increase donations, reduce fundraising costs, improve communications with constituents, manage their finances and optimize internal operations. We continue to make investments in our product portfolio and go-to-market organization to ensure we are properly positioned to benefit from shifts in the market, including demand for our subscription-based offerings. As of September 30, 2013, we had over 29,000 active customers distributed across multiple verticals within the nonprofit market including education, foundations, health and human services, religion, arts and cultural, public and societal benefits, environment and animal welfare, as well as international foreign affairs.

We derive revenue from charging for the use of our software products in a hosted environment, selling perpetual licenses and providing a broad offering of services, including consulting, training, installation and implementation services, as well as ongoing customer support and maintenance. Consulting, training and implementation are generally not essential to the functionality of our software products and are sold separately. Furthermore, we derive revenue from providing hosting services, performing donor prospect research engagements, selling lists of potential donors, and providing transaction processing services, benchmarking studies and data modeling services.

In August 2013, we announced that Anthony Boor, Senior Vice President and Chief Financial Officer of Blackbaud, had been named to the additional role of Interim President and Chief Executive Officer until a permanent CEO is appointed. Mr. Boor has continued to maintain his responsibilities as CFO. Our Board of Directors has a search underway for a permanent CEO.

We completed our acquisition of Convio in May 2012 for $335.7 million in consideration. We have included the results of operations of Convio in our consolidated results of operations from the date of acquisition, which impacts the comparability of our results of operations for the nine months ended September 30, 2013 and 2012. Because we have integrated a substantial amount of the Convio operations and have made product rationalization decisions, it is not possible to determine the revenue and operating costs attributable solely to the acquired business.

Overall, revenue for the three and nine months ended September 30, 2013 increased 4% and 13% when compared to the same periods in 2012, respectively. These increases were primarily the result of growth in demand for our online and hosted solutions, including Luminate Online, as our business continues to shift towards subscription-based offerings. An increase in the volume of transactions for which we process payments also contributed to the increase in subscription revenue. Services revenue increased during the nine months ended September 30, 2013 primarily due to growth in consulting service revenue, driven by the inclusion of Convio. License revenue decreased during the three and nine months ended September 30, 2013 when compared to the same periods in 2012 as a result of a smaller contribution of revenue from sales of our offerings under perpetual license arrangements as well as the continued shift in our business from perpetual license-based offerings to subscription-based offerings.

Income from operations for the three and nine months ended September 30, 2013 increased by $11.8 million and $27.3 million when compared to the same periods in 2012, respectively. These increases in income from operations were primarily attributable to the inclusion of Convio's subscription-based offerings, which have historically yielded higher gross margins than our historical subscription-based offerings, an increase in demand for our online fundraising offerings and our payment processing services, which have also historically yielded higher gross margins than our other offerings and a reduction in costs from improved operational efficiencies as we integrated the Convio operations. Also contributing to the increases in income from operations for the three and nine months ended September 30, 2013 compared to the same periods in 2012 were net decreases of $2.0 million and $5.3 million, respectively, in costs associated with our acquisition of Convio related to transaction

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and integration costs and amortization of acquired intangibles as well as decreases of $0.3 million and $2.9 million, respectively, in costs related to strategic investments we made during 2012 for our business optimization efforts and the re-engineering of our accounting processes. These increases in income from operations were partially offset by $1.0 million and $2.1 million of incremental costs incurred during the three and nine months ended September 30, 2013, respectively, associated with our CEO search and CEO severance.

At September 30, 2013, our cash and cash equivalents were $16.7 million and outstanding borrowings on our credit facility were $173.7 million. During the nine months ended September 30, 2013, we generated $78.0 million in cash flow from operations, paid $16.5 million in dividends, used $13.4 million to purchase computer equipment and software and reduced our debt balance by $41.8 million.

During the three months ended September 30, 2013, we continued to experience growth in overall revenue primarily driven by the inclusion of Convio's product offerings and the growing demand for our subscription-based offerings. However, we continue to believe that the pace and impact of economic recovery on the nonprofit market remains uncertain. Notwithstanding these conditions, we plan to further increase our focus on subscription-based offerings as we execute on our key growth initiatives and strengthen our leadership position, while achieving our targeted level of profitability. In the near term, we anticipate there will continue to be a dilutive impact on our profitability as we invest in our product portfolio to meet demand for our subscription offerings and shift from a perpetual license-based model, with upfront revenue recognition to a subscription-based model, with recognition of revenue occurring ratably over the subscription term.

We also plan to continue to invest in our product, sales and marketing organizations and our back-office processes; the infrastructure that supports our subscription-based offerings and certain product development initiatives to achieve optimal scalability of our operations as we execute on our key growth initiatives.

Comparison of the three and nine months ended September 30, 2013 and 2012

Results of operations

We completed the acquisition of Convio on May 4, 2012. Because we have integrated a substantial amount of the Convio operations and have made product rationalization decisions, it is not possible to determine the revenue and operating costs attributable solely to the acquired business.

We have included the results of operations of Convio in our consolidated results of operations from the date of acquisition, which impacts the comparability of our results of operations for the nine months ended September 30, 2013 and 2012. We have noted in the discussion below, to the extent meaningful, the impact on the comparability of our consolidated results of operations due to the inclusion of Convio.

Revenue by segment

The table below compares revenue by segment for the three and nine months ended September 30, 2013, with the same periods in 2012.

	Three months ended September 30,				Nine months ended September 30,			
(in millions)	2013	2012	Change	% Change	2013	2012	Change	% Change
ECBU	$49.3	$46.2	$3.1	7 %	$143.2	$121.7	$21.5	18 %
GMBU	55.8	54.7	1.1	2 %	164.7	148.2	16.5	11 %
IBU	10.8	10.6	0.2	2 %	30.8	29.6	1.2	4 %
Target Analytics	12.0	11.0	1.0	9 %	30.2	27.9	2.3	8 %
Other	—	—	—	— %	—	—	—	— %
Total revenue	$127.9	$122.5	$5.4	4 %	$368.9	$327.4	$41.5	13 %

The increases in revenue for ECBU and GMBU during the three and nine months ended September 30, 2013 when compared to the same periods in 2012 were primarily attributable to growth in subscriptions revenue as a result of the inclusion of Luminate Online, previously a Convio product, and an increase in the volume of transactions for which we process payments. Also contributing to the growth in GMBU revenue was the continued increase in demand for our online and hosted solutions as our

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business shifts towards subscription-based offerings. Also contributing to the growth in ECBU revenue was an increase in revenue from our Blackbaud CRM hosting services.

IBU revenue increased during the three and nine months ended September 30, 2013 when compared to the same periods in 2012 primarily due to incremental subscriptions revenue. The growth in IBU subscriptions revenue was primarily attributable to an increase in demand for our online and hosted fundraising solutions including eTapestry, Everyday Hero and the Raiser's Edge. Also contributing to the increase in IBU subscriptions revenue was an increase in variable transaction fees associated with the use of our products to fundraise online.

Target Analytics revenue growth during the three and nine months ended September 30, 2013 when compared to the same periods in 2012 was primarily the result of an increase in demand for our prospect research offerings and improved sales execution driven by our new sales leadership team.

Operating results

License fees

	Three months ended September 30,				Nine months ended September 30,			
(in millions)	2013	2012	Change	% Change	2013	2012	Change	% Change
License fees revenue	$3.8	$4.5	$(0.7)	(16)%	$12.8	$16.2	$(3.4)	(21)%
Cost of license fees	0.5	0.7	(0.2)	(29)%	1.9	2.2	(0.3)	(14)%
License fees gross profit	$3.3	$3.8	$(0.5)	(13)%	$10.9	$14.0	$(3.1)	(22)%
License fees gross margin	87%	84%			85%	86%		

We derive license fees revenue from the sale of our software products under a perpetual license agreement. During the three and nine months ended September 30, 2013, revenue from license fees decreased as a result of smaller contributions of revenue from our Blackbaud CRM, Education Edge and Raiser's Edge offerings when compared to the same periods in 2012. Our larger perpetual license transactions, such as those for Blackbaud CRM, have long sales cycles and their timing can result in significant period-to-period variations in revenue. Additionally, we continue to meet the demand of our emerging and mid-sized customers’ that increasingly prefer subscription-based hosted applications instead of solutions offered under traditional on-premise perpetual license arrangements. Also contributing to the decreases in revenue from license fees was a change in presentation from gross to net for revenue and costs associated with certain third-party software arrangements that had changes in contractual terms effective January 2013. The net revenue attributable to these third-party software arrangements has been included in "Other revenue" for 2013.

Cost of license fees is primarily comprised of third-party software royalties, variable reseller commissions, amortization of software development costs and amortization of intangibles from business combinations. The decrease in cost of license fees during the three and nine months ended September 30, 2013 when compared to the same periods in 2012 was primarily due to a decrease in third-party software royalties resulting from a change in presentation from gross to net for revenue and costs associated with certain third-party software arrangements that had changes in contractual terms effective January 2013.

The increase in license fees gross margin for the three months ended September 30, 2013 when compared to the same period in 2012 was primarily due to the large reduction in third-party software royalties recorded in cost of license fees relative to the decrease in license fees revenue, which resulted from the change in presentation from gross to net

for revenue and costs discussed above. License fees gross margin for the nine months ended September 30, 2013 when compared to the same period in 2012 remained relatively unchanged.

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Subscriptions

	Three months ended September 30,				Nine months ended September 30,			
(in millions)	2013	2012	Change	% Change	2013	2012	Change	% Change
Subscriptions revenue	$52.0	$47.4	$4.6	10 %	$151.8	$113.4	$38.4	34 %
Cost of subscriptions	21.5	19.6	1.9	10 %	63.5	49.2	14.3	29 %
Subscriptions gross profit	$30.5	$27.8	$2.7	10 %	$88.3	$64.2	$24.1	38 %
Subscriptions gross margin	59 %	59 %			58 %	57 %		

Revenue from subscriptions is primarily comprised of revenue from charging for the use of our software products, which includes providing access to hosted applications and hosting services, access to certain data services and our online subscription training offerings, as well as revenue from variable transaction fees associated with the use of our products to fundraise online. We continue to experience growth in sales of our hosted applications and hosting services as we meet the demand of our emerging and mid-sized customers that increasingly prefer subscription-based offerings.

The increase in subscriptions revenue during the three and nine months ended September 30, 2013 when compared to the same periods in 2012 was primarily attributable to an increase in demand for our online fundraising offerings, including Luminate Online, previously a Convio product. Also contributing to the growth in subscriptions revenue was an increase in the volume of transactions for which we process payments.
Cost of subscriptions is primarily comprised of human resource costs, stock-based compensation expense, third-party royalty and data expenses, hosting expenses, allocated depreciation, facilities and IT support costs, amortization of intangibles from business combinations and other costs incurred in providing support and services to our customers.
The increase in cost of subscriptions during the three and nine months ended September 30, 2013 when compared to the same periods in 2012 was primarily attributable to increases in amortization of intangibles from business combinations, hosting costs, human resource costs and allocated depreciation, facilities and IT support costs.
Amortization of intangibles from business combinations increased by $0.6 million and $6.2 million during the three and nine months ended September 30, 2013 when compared to the same periods in 2012, respectively. The increase in amortization expense during the three months ended September 30, 2013 when compared to the same period in 2012 was primarily the result of an adjustment to the purchase price allocation for Convio recorded during the three months ended September 30, 2012. The increase in amortization during the nine months ended September 30, 2013 when compared to the same period in 2012 was primarily due to the inclusion of Convio.
Hosting costs increased by $1.0 million and $2.9 million during the three and nine months ended September 30, 2013 when compared to the same periods in 2012, respectively. Human resource costs increased $0.5 million and $2.3 million during the three and nine months ended September 30, 2013 when compared to the same periods in 2012, respectively. Allocated depreciation, facilities and IT support costs increased by $0.4 million and $2.4 million, respectively, during the three and nine months ended September 30, 2013 when compared to the same periods in 2012. The increases in hosting costs, human resource costs and allocated depreciation, facilities and IT support costs during the three months ended September 30, 2013 when compared to the same period in 2012 were primarily a result of investments made to support anticipated growth in our subscription-based offerings. The increases in these costs during the nine months ended September 30, 2013 when compared to the same period in 2012 were primarily due to the inclusion of Convio.

Subscriptions gross margin for the three months ended September 30, 2013 when compared to the same period in 2012 remained relatively unchanged. The increase in subscriptions gross margin for the nine months ended September 30, 2013 when compared to the same period in 2012 was primarily a result of the inclusion of Convio's subscription-based offerings for the full nine month period in 2013 compared to only five months in 2012, which have historically yielded higher gross margins than our historical subscription-based offerings. Also contributing to the increase in subscriptions gross margin was an increase in transaction revenue associated with our payment processing services, which have also historically yielded higher gross margins than our other offerings. Partially offsetting these increases in subscriptions gross margin were investments we have made to support anticipated growth in our subscription-based offerings.

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Services

(in millions)	Three months ended September 30, 2013	2012	Change	% Change	Nine months ended September 30, 2013	2012	Change	% Change
Services revenue	$35.4	$34.5	$0.9	3 %	$95.6	$90.2	$5.4	6 %
Cost of services	26.1	26.4	(0.3)	(1)%	78.0	71.8	6.2	9 %
Services gross profit	$9.3	$8.1	$1.2	15 %	$17.6	$18.4	$(0.8)	(4)%
Services gross margin	26 %	23 %			18 %	20 %		

We derive services revenue from consulting, installation, implementation, education and analytic services. Consulting, installation and implementation services involve converting data from a customer’s existing system, assistance in file set up and system configuration, and/or process re-engineering. Education services involve customer training activities. Analytic services are comprised of donor prospect research, sales of lists of potential donors, benchmarking studies and data modeling services. These services involve the assessment of current and prospective donor information of the customer and are performed using our proprietary analytical tools. The end product is intended to enable organizations to more effectively target their fundraising activities. We typically recognize services revenue upon delivery. We also recognize the direct and incremental costs associated with consulting services revenue as earned. However, we continue to expense indirect costs in the period the implementation services are provided. We recognize the revenue for upfront activation fees ratably over the estimated period the customer benefits from those services.

The increase in services revenue during the three months ended September 30, 2013 when compared to the same period in 2012 was primarily attributable to an increase of $0.4 million in education services revenue in the 2013 period as well as the write down of $0.4 million of Convio's deferred revenue balance during the 2012 period. The increases in revenue were the result of higher demand for subscription-based training.

The increase in services revenue during the nine months ended September 30, 2013 when compared to the same period in 2012 was attributable to increases in consulting, analytic and education services revenue of $3.0 million, $1.1 and $1.3 million, respectively. Consulting services revenue increased primarily due to the inclusion of Convio for the full period in 2013 compared to only five months in 2012. Analytic services revenue increased primarily due to an increase in demand for our prospect research offerings and improved sales execution driven by our new sales leadership team. The volume of education services revenue increased due to higher demand for subscription-based training.

Cost of services is primarily comprised of human resource costs, stock-based compensation expense, third-party contractor expenses, classroom rentals, costs incurred in providing customer training, data expense incurred to perform analytic services, allocated depreciation, facilities and IT support costs and amortization of intangibles from business combinations. The decrease in cost of services during the three months ended September 30, 2013 when compared to the same period in 2012 was primarily attributable to a decrease in human resource costs as a result of a reduction in headcount in connection with the realignment of our workforce, which began in January 2013 and improvements in organizational efficiencies from that realignment.

The increase in cost of services during the nine months ended September 30, 2013 when compared to the same period in 2012 was primarily attributable to an increase in human resource costs, amortization of intangibles from business combinations and allocated depreciation, facilities and IT support costs. Human resource costs increased $3.9 million primarily as a result of an increase in average headcount and merit-based salary increases. The increase in average headcount was primarily attributable to the inclusion of additional resources from Convio for the full period in 2013 compared to only five months in 2012. Allocated depreciation, facilities and IT support costs increased $1.2 million

due to the inclusion of allocable costs from the Convio operations as well as investments we have made in our infrastructure to make our operations more scalable. Amortization of intangibles from business combinations increased $0.4 million due to the inclusion of Convio for the full period in 2013 compared to only five months in 2012.
Services gross margin increased for the three months ended September 30, 2013 when compared to the same period in 2012 primarily from increases in operational efficiencies. Services gross margin decreased for the nine months ended September 30, 2013 when compared to the same period in 2012 primarily due to increases in human resource costs and allocated costs outpacing the growth of services revenue. Since our acquisition of Convio in May 2012, we have made significant progress integrating operations and realizing gross margin synergies from the combination, which is reflected in the comparison of the three months ended September 30, 2013 to the 2012 period. While this trend is applicable to the nine months ended September

30, 2013, the impact is obscured by the inclusion in that period of nine months of Convio operating results compared to only five months in the 2012 period.

Maintenance

	Three months ended September 30,				Nine months ended September 30,			
(in millions)	2013	2012	Change	% Change	2013	2012	Change	% Change
Maintenance revenue	$34.7	$34.5	$0.2	1 %	$103.0	$101.9	$1.1	1 %
Cost of maintenance	6.7	6.8	(0.1)	(1)%	19.1	18.9	0.2	1 %
Maintenance gross profit	$28.0	$27.7	$0.3	1 %	$83.9	$83.0	$0.9	1 %
Maintenance gross margin	81 %	80 %			81 %	81 %		

Revenue from maintenance is comprised of annual fees derived from maintenance contracts associated with new software licenses and annual renewals of existing maintenance contracts. These contracts provide customers with updates, enhancements and upgrades to our software products and online, telephone and email support. Maintenance contracts are typically for a term of one year, and maintenance renewal rates in the periods reported did not vary materially compared to prior periods. The increase in maintenance revenue during the three months ended September 30, 2013 when compared to the same period in 2012 was primarily comprised of (i) $2.5 million of incremental maintenance from new customers associated with new license agreements and increases in contracts with existing customers; and (ii) approximately $1.1 million of incremental maintenance from contract inflationary rate adjustments; partially offset by (iii) a $2.2 million reduction in maintenance from contracts that were not renewed and reductions in contracts with existing customers; and (iv) a $0.8 million decrease in maintenance revenue attributable to a change in presentation from gross to net for revenue and costs associated with certain third-party software arrangements that had changes in contractual terms effective January 2013. The net revenue attributable to these third-party software arrangements has been included in "Other revenue" for 2013.

The increase in maintenance revenue during the nine months ended September 30, 2013 when compared to the same period in 2012 was primarily comprised of (i) $7.5 million of incremental maintenance from new customers associated with new license agreements and increases in contracts with existing customers; and (ii) approximately $3.1 million of incremental maintenance from contract inflationary rate adjustments; partially offset by (iii) a $6.7 million reduction in maintenance from contracts that were not renewed and reductions in contracts with existing customers; and (iv) $2.5 million decrease in maintenance revenue attributable to a change in presentation from gross to net for revenue and costs associated with certain third-party software arrangements that had changes in contractual terms effective January 2013. The net revenue attributable to these third-party software arrangements has been included in "Other revenue" for 2013.

Cost of maintenance is primarily comprised of human resource costs, stock-based compensation expense, third-party contractor expenses, third-party royalty costs, allocated depreciation, facilities and IT support costs, amortization of intangibles from business combinations and other costs incurred in providing support and services to our customers.

Cost of maintenance decreased during the three months ended September 30, 2013 when compared to the same period in 2012 primarily as a result of decreases in proprietary software costs and allocated depreciation, facilities and IT support costs, partially offset by an increase in human resource costs. Cost of maintenance increased during the nine months ended September 30, 2013 when compared to the same period in 2012 primarily due to increases in human resource costs and allocated depreciation, facilities and IT support costs, partially offset by a decrease in proprietary software costs. The increases in human resource costs were primarily due to a refinement in our methodology for allocating employee benefit costs. The decreases in proprietary software costs were primarily attributable to a change

in presentation from gross to net for revenue and costs associated with certain third-party software arrangements that had changes in contractual terms effective January 2013.

Maintenance gross margin for the three and nine months ended September 30, 2013 when compared to the same periods in 2012 remained relatively unchanged.

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Other revenue

	Three months ended September 30,			Nine months ended September 30,
(in millions)	2013	2012	Change	