SERVICESOURCE INTERNATIONAL, INC.
Form 10-Q
November 08, 2013
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q
(Mark One)
x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 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 001-35108
SERVICESOURCE INTERNATIONAL, INC.
(Exact name of registrant as specified in our charter)

Delaware (State or Other Jurisdiction of Incorporation or Organization)	No. 81-0578975 (I.R.S. Employer Identification No.)
634 Second Street San Francisco, California (Address of Principal Executive Offices)	94107 (Zip Code)

(415) 901-6030
(Registrant's Telephone Number, Including Area Code)
Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No x
Indicate number of shares outstanding of each of the issuer's classes of common stock, as of the latest practical date:

Class	Outstanding as of October 31, 2013
Common Stock	81,095,945

Table of Contents

SERVICESOURCE INTERNATIONAL, INC.
Form 10-Q
INDEX

	Page No.
PART I. FINANCIAL INFORMATION	
Item 1. Financial Statements (unaudited)	3
Condensed Consolidated Balance Sheets as of September 30, 2013 and December 31, 2012	3
Condensed Consolidated Statements of Operations for the three and nine months ended September 30, 2013 and 2012	4
Condensed Consolidated Statements of Comprehensive Loss for the three and nine months ended September 30, 2013 and 2012	5
Condensed Consolidated Statements of Cash Flows for the nine months ended September 30, 2013 and 2012	6
Notes to Unaudited Condensed Consolidated Financial Statements	7
Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations	18
Item 3. Quantitative and Qualitative Disclosures About Market Risk	32
Item 4. Controls and Procedures	32
PART II. OTHER INFORMATION	
Item 1. Legal Proceedings	34
Item 1A. Risk Factors	34
Item 2. Unregistered Sales of Equity Securities and Use of Proceeds	50
Item 3. Default Upon Senior Securities	50
Item 4. Mine Safety Disclosures	50
Item 5. Other Information	50
Item 6. Exhibits	50
Signatures	51
Exhibit Index	52

Table of Contents

PART I FINANCIAL INFORMATION

Item 1. Financial Statements
SERVICESOURCE INTERNATIONAL, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands)
(Unaudited)

	September 30, 2013	December 31, 2012
Assets		
Current assets:		
Cash and cash equivalents	$174,674	$76,568
Short-term investments	103,604	32,874
Accounts receivable, net	63,889	65,238
Deferred income taxes	286	389
Prepaid expenses and other	5,245	5,178
Total current assets	347,698	180,247
Property and equipment, net	28,150	34,513
Deferred debt issuance costs, net	3,535	71
Deferred income taxes, net of current portion	1,921	2,321
Other assets, net	761	986
Goodwill	6,334	6,334
Total assets	$388,399	$224,472
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	$5,698	$3,293
Accrued taxes	2,168	1,056
Accrued compensation and benefits	16,988	15,738
Accrued liabilities and other	12,932	10,403
Obligations under capital leases	333	326
Total current liabilities	38,119	30,816
Convertible notes, net	112,302	—
Obligations under capital leases, net of current portion	398	638
Other long-term liabilities	4,692	6,091
Total liabilities	155,511	37,545
Commitments and contingencies (Note 7)		
Stockholders' equity:		
Common stock; $0.0001 par value; 1,000,000 shares authorized; 81,072 shares issued and 80,951 shares outstanding as of September 30, 2013; 75,758 shares issued and 75,637 shares outstanding as of December 31, 2012	8	8
Treasury stock	(441)	(441)
Additional paid-in capital	277,309	210,650
Accumulated deficit	(44,261)	(23,398)
Accumulated other comprehensive income	273	108
Total stockholders' equity	232,888	186,927
Total liabilities and stockholders' equity	$388,399	$224,472

The accompanying notes are an integral part of these Condensed Consolidated Financial Statements.

3

Table of Contents

SERVICESOURCE INTERNATIONAL, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except per share amounts)
(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Net revenue	$66,482	$59,090	$195,300	$176,358
Cost of revenue	39,730	34,544	116,848	101,002
Gross profit	26,752	24,546	78,452	75,356
Operating expenses:				
Sales and marketing	13,731	13,512	43,906	41,158
Research and development	5,500	4,416	18,542	13,295
General and administrative	11,177	10,000	33,182	30,639
Total operating expenses	30,408	27,928	95,630	85,092
Loss from operations	(3,656)	(3,382)	(17,178)	(9,736)
Other income (expense):				
Interest expense	(1,272)	(70)	(1,376)	(180)
Other, net	179	190	(119)	(124)
Loss before income taxes	(4,749)	(3,262)	(18,673)	(10,040)
Income tax provision	753	322	2,190	31,589
Net loss	$(5,502)	$(3,584)	$(20,863)	$(41,629)
Net loss per share, basic and diluted	$(0.07)	$(0.05)	$(0.27)	$(0.56)
Weighted average common shares outstanding, basic and diluted	79,740	74,667	77,557	73,994

The accompanying notes are an integral part of these Condensed Consolidated Financial Statements.

Table of Contents

SERVICESOURCE INTERNATIONAL, INC.
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS
(In thousands)
(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Net loss	$(5,502)	$(3,584)	$(20,863)	$(41,629)
Other comprehensive income, net of tax:				
Foreign currency translation adjustments	(180)	(119)	32	(192)
Unrealized gain on short-term investments, net of tax	254	(36)	134	(10)
Other comprehensive income, net of tax	74	(155)	166	(202)
Total comprehensive loss, net of tax	$(5,428)	$(3,739)	$(20,697)	$(41,831)

The accompanying notes are an integral part of these Condensed Consolidated Financial Statements.

Table of Contents

SERVICESOURCE INTERNATIONAL, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)
(Unaudited)

	Nine Months Ended September 30, 2013	2012
Cash flows from operating activities		
Net loss	$(20,863)	$(41,629)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	9,010	7,092
Amortization of debt discount and issuance costs	960	135
Accretion of premium on short-term investments	569	577
Deferred income taxes	504	32,534
Stock-based compensation	17,301	15,260
Income tax charge (benefit) from stock-based compensation	249	(266)
Changes in operating assets and liabilities:		
Accounts receivable, net	1,527	(4,237)
Prepaid expenses and other	(174)	734
Accounts payable	2,581	(1,087)
Accrued taxes	1,110	85
Accrued compensation and benefits	1,227	(5,094)
Accrued liabilities and other	763	5,050
Net cash provided by operating activities	14,764	9,154
Cash flows from investing activities		
Acquisition of property and equipment	(3,108)	(17,049)
Purchases of short-term investments	(78,502)	(31,100)
Sales of short-term investments	5,336	52,050
Maturities of short-term investments	2,000	21,415
Net cash used in (provided by) investing activities	(74,274)	25,316
Cash flows from financing activities		
Proceeds from issuance of convertible notes	150,000	—
Issuance costs related to the issuance of convertible senior notes	(4,350)	—
Payments of convertible note hedges	(31,408)	—
Proceeds from the issuance of warrants	21,763	—
Repayment on capital leases obligations	(245)	(234)
Proceeds from common stock issuances	21,969	10,279
Income tax charge (benefit) from stock-based compensation	(249)	266
Net cash provided by financing activities	157,480	10,311
Net increase in cash and cash equivalents	97,970	44,781
Effect of exchange rate changes on cash and cash equivalents	136	(487)
Cash and cash equivalents at beginning of period	76,568	65,983
Cash and cash equivalents at end of period	$174,674	$110,277

The accompanying notes are an integral part of these Condensed Consolidated Financial Statements.

Table of Contents

SERVICESOURCE INTERNATIONAL, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Note 1 — Description of Business and Basis of Presentation

ServiceSource International, Inc. (together with its subsidiaries, the "Company") is a global leader in recurring revenue management, partnering with technology and technology-enabled companies to optimize maintenance, support and subscription revenue streams, while also improving customer relationships and loyalty. The Company delivers these results via a cloud-based solution, with dedicated service teams, leveraging benchmarks and best practices derived from their rich database of service and renewal behavior. By integrating software, managed services and data, the Company provides end-to-end management and optimization of the service-contract renewals process, including data management, quoting, selling and recurring revenue business intelligence. The Company receives commissions from its customers based on renewal sales that the Company generates on their behalf under a pay-for-performance model. In addition, the Company recently began to offer a purpose-built Software-As-A-Service (SaaS) application to maximize the renewal of subscriptions, maintenance and support contracts. The Company's corporate headquarters are located in San Francisco, California. The Company has offices in Colorado, Tennessee, the United Kingdom, Ireland, Malaysia and Singapore.

The accompanying unaudited interim condensed consolidated financial statements ("condensed consolidated financial statements") include the accounts of ServiceSource International Inc. and its subsidiaries. Intercompany accounts and transactions have been eliminated in consolidation.

These condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles in the United States ("U.S. GAAP" or "GAAP") for interim financial information, rules and regulations of the Securities and Exchange Commission ("SEC") for interim financial statements, and accounting policies, consistent in all material respects with those applied in preparing our audited annual consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2012. These condensed consolidated financial statements and accompanying notes should be read in conjunction with our annual consolidated financial statements and the notes thereto for the year ended December 31, 2012, included in our Annual Report on Form 10-K. In the opinion of management, these condensed consolidated financial statements reflect all adjustments, including normal recurring adjustments, management considers necessary for a fair statement of our financial position, operating results, and cash flows for the interim periods presented. The results for the interim periods are not necessarily indicative of results for the entire year.

The December 31, 2012 condensed consolidated balance sheet data was derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States of America. These unaudited interim condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and related notes for the year ended December 31, 2012 included in the Company's Annual Report on Form 10-K.

Recent Accounting Pronouncements

In February 2013, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2013-2 "Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income." ASU No. 2013-2 requires an entity to disaggregate the total change of each component of other comprehensive income either on the face of the income statement or as a separate disclosure in the notes. The new guidance became effective for the Company's interim period ended March 31, 2013. The Company adopted this guidance and the adoption did not have any impact on its financial position, results of operations or cash flows as the amounts reclassified out of accumulated other comprehensive income is not material.

In June 2013, the FASB determined that an unrecognized tax benefit should be presented as a reduction of a deferred tax asset for a net operating loss ("NOL") carryforward or other tax credit carryforward when settlement in this manner is available under applicable tax law. This guidance is effective for the Company's interim and annual periods beginning January 1, 2014. The Company does not believe the adoption of this guidance will have a material impact on its consolidated financial statements.

Note 2 — Cash, cash equivalents and short-term investments

Cash equivalents consist of highly liquid fixed-income investments with original maturities of three months or less at the time of purchase, including money market funds. Short-term investments consist of readily marketable securities with a remaining maturity of more than three months from time of purchase. The Company classifies all of its cash equivalents and short-term investments as “available for sale,” as these investments are free of trading restrictions. These marketable securities are carried at fair value, with the unrealized gains and losses, net of tax, reported as accumulated other comprehensive income and included as a separate component of stockholders’ equity. Gains and losses are recognized when realized. When the Company determines that an other-than-temporary decline in fair value has occurred, the amount of the decline that is related to

Table of Contents

a credit loss is recognized in earnings. Gains and losses are determined using the specific identification method. The Company's realized gains and losses in the three and nine months ended September 30, 2013 and 2012 were insignificant.

Cash and cash equivalents and short-term investments consisted of the following as of September 30, 2013 and December 31, 2012 (in thousands):

September 30, 2013

	Amortized Cost	Unrealized Gains	Unrealized Losses	Estimated Fair Value
Cash	$31,706	$—	$—	$31,706
Cash equivalents:				
Money market mutual funds	142,968	—	—	142,968
Total cash and cash equivalents	174,674	—	—	174,674
Short-term investments:				
Corporate bonds	39,518	57	(20)	39,555
U.S. agency securities	32,235	45	(6)	32,274
Asset-backed securities	13,968	9	(20)	13,957
U.S. Treasury securities	17,760	58	—	17,818
Total short-term investments	103,481	169	(46)	103,604
Cash, cash equivalents and short-term investments	$278,155	$169	$(46)	$278,278

December 31, 2012

	Amortized Cost	Unrealized Gains	Unrealized Losses	Estimated Fair Value
Cash	$59,568	$—	$—	$59,568
Cash equivalents:				
Money market mutual funds	17,000	—	—	17,000
Total cash and cash equivalents	76,568	—	—	76,568
Short-term investments:				
Corporate bonds	13,389	2	(14)	13,377
U.S. agency securities	11,280	4	(1)	11,283
Asset-backed securities	4,670	1	(5)	4,666
U.S. Treasury securities	3,546	2	—	3,548
Total short-term investments	32,885	9	(20)	32,874
Cash, cash equivalents and short-term investments	$109,453	$9	$(20)	$109,442

The following table summarizes the cost and estimated fair value of short-term fixed income securities classified as short-term investments based on stated maturities as of September 30, 2013:

	Amortized Cost	Estimated Fair Value
Less than 1 year	$8,828	$8,834
Due in 1 to 5 years	94,653	94,770
Total	$103,481	$103,604

As of September 30, 2013, the Company did not consider any of its investments to be other-than-temporarily impaired.

Note 3 — Fair value of financial instruments

Table of Contents

The Company measures certain financial instruments at fair value on a recurring basis. The Company uses a three-tier fair value hierarchy, which prioritizes the inputs used in the valuation methodologies in measuring fair value:
Level 1 valuations are based on quoted prices in active markets for identical assets or liabilities.

Level 2 valuations are based on inputs that are observable, either directly or indirectly, other than quoted prices included within Level 1. Such inputs used in determining fair value for Level 2 valuations include quoted prices in active markets for similar assets or liabilities, quoted prices for identical or similar assets or liabilities in markets that are not active, or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.
Level 3 valuations are based on information that is unobservable and significant to the overall fair value measurement.
All of the Company's cash equivalents and short-term investments are classified within Level 1 or Level 2.
The following table presents information about the Company's financial instruments that are measured at fair value as of September 30, 2013 and indicates the fair value hierarchy of the valuation (in thousands):

Description	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)
Cash equivalents:			
Money market mutual funds	$142,968	$142,968	$—
Total cash equivalents	142,968	142,968	—
Short-term investments:			
Corporate bonds	39,555	—	39,555
U.S. agency securities	32,274	—	32,274
Asset-backed securities	13,957	—	13,957
U.S. Treasury securities	17,818	—	17,818
Total short-term investments	103,604	—	103,604
Cash equivalents and short-term investments	$246,572	$142,968	$103,604

The following table presents information about the Company's financial instruments that are measured at fair value as of December 31, 2012 and indicates the fair value hierarchy of the valuation (in thousands):

Description	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)
Cash equivalents:			
Money market mutual funds	$17,000	$17,000	$—
Total cash equivalents	17,000	17,000	—
Short-term investments:			
Corporate bonds	13,377	—	13,377
U.S. agency securities	11,283	—	11,283
Asset-backed securities	4,666	—	4,666
U.S. Treasury securities	3,548	—	3,548

Total short-term investments	32,874	—	32,874
Cash equivalents and short-term investments	$49,874	$17,000	$32,874

Table of Contents

The convertible notes issued by the Company in August 2013 are shown in the accompanying consolidated balance sheets at their original issuance value, net of unamortized discount, and are not marked to market each period. The fair value of the convertible notes approximates the notes carrying value as of September 30, 2013. The fair value of the convertible notes was determined using quoted market prices for similar securities, which, due to limited trading activity, are considered Level 2 in the fair value hierarchy.

The Company did not have any financial liabilities measured at fair value as of December 31, 2012.

Note 4 — Property and Equipment, Net

Property and equipment balances were comprised of the following (in thousands):

	September 30, 2013	December 31, 2012
Computers and equipment	$16,672	$14,733
Software	33,603	32,982
Furniture and fixtures	8,670	8,555
Leasehold improvements	10,911	10,801
	69,856	67,071
Less: accumulated depreciation and amortization	(41,706)	(32,558)
Property and equipment – net	$28,150	$34,513

Depreciation and amortization expense during the three and nine months ended September 30, 2013 and the three and nine months ended September 30, 2012, was $3.0 million, $9.0 million, $2.5 million and $7.1 million respectively. Total property and equipment assets under capital lease at September 30, 2013 and December 31, 2012, was $3.2 million and $3.2 million, respectively. Accumulated depreciation related to assets under capital lease as of these dates were $2.5 million and $2.1 million, respectively.

The Company capitalized internal-use software development costs of $0 and $1.5 million during the three months ended September 30, 2013 and 2012, respectively and $0 and $6.6 million during the nine months ended September 30, 2013 and 2012, respectively. As of September 30, 2013 and December 31, 2012, the net value of capitalized costs related to internal-use software, net of accumulated amortization, was $9.8 million and $13.6 million, respectively. Amortization of capitalized costs related to internal-use software for the three months ended September 30, 2013 and 2012 was $1.3 million and $0.8 million, respectively, and for the nine months ended September 30, 2013 and 2012 was $3.8 million and $2.1 million, respectively.

Note 5 — Accrued Liabilities and Other

Accrued liabilities and other balances were comprised of the following (in thousands):

	September 30, 2013	December 31, 2012
Deferred revenue	$4,519	$2,295
Accrued operating expenses	3,128	3,664
Deferred rent obligations	861	986
Other employee related	482	323
Accrued other (includes ESPP contributions of $330 and $1,059 at September 30, 2013 and December 31, 2012, respectively)		