

WAGEWORKS, INC.
Form 10-Q
November 09, 2016

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

FORM 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2016

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: 001-35232

WAGEWORKS, INC.
(Exact name of Registrant as specified in its charter)

Delaware 94-3351864
(State or other jurisdiction of (I.R.S. Employer
incorporation or organization) Identification No.)

San Mateo, California
1100 Park Place, 4th Floor 94403
San Mateo, California (Zip Code)
(Address of principal executive offices)

(650) 577-5200
(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 ("Exchange Act") during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted to its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and

Edgar Filing: WAGEWORKS, INC. - Form 10-Q

post such files). Yes No

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

Large accelerated filer

Accelerated filer

Non-accelerated filer (Do not check if a smaller reporting company) Smaller reporting company

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

As of November 2, 2016, there were 36,642,414 shares of the registrant’s common stock outstanding.

WAGEWORKS, INC.
FORM 10-Q QUARTERLY REPORT
Table of Contents

	Page No.
<u>PART I. FINANCIAL INFORMATION</u>	
<u>Item 1. Financial Statements</u>	<u>3</u>
<u>Consolidated Balance Sheets as of December 31, 2015 and September 30, 2016</u>	<u>3</u>
<u>Consolidated Statements of Income for the Three and Nine Months Ended September 30, 2015 and 2016</u>	<u>4</u>
<u>Consolidated Statements of Cash Flows for the Nine Months Ended September 30, 2015 and 2016</u>	<u>5</u>
<u>Notes to Consolidated Financial Statements</u>	<u>6</u>
<u>Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations</u>	<u>17</u>
<u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u>	<u>25</u>
<u>Item 4. Controls and Procedures</u>	<u>26</u>
<u>PART II. OTHER INFORMATION</u>	
<u>Item 1. Legal Proceedings</u>	<u>26</u>
<u>Item 1A. Risk Factors</u>	<u>26</u>
<u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>	<u>26</u>
<u>Item 6. Exhibits</u>	<u>26</u>
<u>Signatures</u>	<u>28</u>

Table of Contents

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

WAGeworks, INC.

Consolidated Balance Sheets

(In thousands, except per share amounts)

	December 31, 2015	September 30, 2016
	Derived from Audited Financial Statements	(Unaudited)
Assets		
Current assets:		
Cash and cash equivalents	\$ 500,918	\$ 666,634
Restricted cash	332	332
Accounts receivable, net	72,271	85,135
Prepaid expenses and other current assets	13,254	21,258
Total current assets	586,775	773,359
Property and equipment, net	47,955	55,451
Goodwill	157,109	157,109
Acquired intangible assets, net	82,616	86,426
Deferred tax assets	9,837	10,261
Other assets	4,447	4,497
Total assets	\$ 888,739	\$ 1,087,103
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable and accrued expenses	\$ 60,541	\$ 69,177
Customer obligations	400,821	549,316
Short-term contingent consideration	739	—
Other current liabilities	2,893	359
Total current liabilities	464,994	618,852
Long-term debt	78,996	78,907
Other non-current liabilities	7,780	9,626
Total liabilities	551,770	707,385
Stockholders' Equity:		
Common stock, \$0.001 par value (authorized 1,000,000 shares; 36,055 shares issued and 35,936 shares outstanding at December 31, 2015 and 36,981 shares issued and 36,636 shares outstanding at September 30, 2016)	36	38
Additional paid-in capital	343,166	380,741
Treasury stock at cost (119 shares at December 31, 2015 and 345 shares at September 30, 2016)	(5,003)	(14,374)
Retained earnings (accumulated deficit)	(1,230)	13,313
Total stockholders' equity	336,969	379,718
Total liabilities and stockholders' equity	\$ 888,739	\$ 1,087,103

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

Table of Contents

WAGeworks, INC.

Consolidated Statements of Income

(In thousands, except per share amounts)

(Unaudited)

	Three Months Ended September 30,		Nine months Ended September 30,	
	2015	2016	2015	2016
Revenues:				
Healthcare	\$42,204	\$48,478	\$133,307	\$146,918
Commuter	16,003	17,580	47,928	52,339
COBRA	12,229	18,670	37,112	51,955
Other	12,724	4,196	32,866	12,439
Total revenues	83,160	88,924	251,213	263,651
Operating expenses:				
Cost of revenues (excluding amortization of internal use software)	26,364	30,566	88,210	90,237
Technology and development	11,560	11,668	33,928	32,656
Sales and marketing	12,824	14,012	38,445	42,317
General and administrative	12,875	16,130	39,559	47,875
Amortization and change in contingent consideration	6,935	6,944	19,946	26,084
Employee termination and other charges	(112)	162	1,968	475
Total operating expenses	70,446	79,482	222,056	239,644
Income from operations	12,714	9,442	29,157	24,007
Other income (expense):				
Interest income	66	117	85	300
Interest expense	(339)	(465)	(1,523)	(1,279)
Other income (expense)	(8)	22	280	24
Income before income taxes	12,433	9,116	27,999	23,052
Income tax provision	(4,835)	(3,222)	(11,244)	(8,509)
Net income	\$7,598	\$5,894	\$16,755	\$14,543
Net income per share:				
Basic	\$0.21	\$0.16	\$0.47	\$0.40
Diluted	\$0.21	\$0.16	\$0.46	\$0.39
Shares used in computing net income per share:				
Basic	35,880	36,605	35,733	36,312
Diluted	36,516	37,454	36,595	37,078

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

Table of Contents

WAGEWORKS, INC.

Consolidated Statements of Cash Flows

(In thousands)

(Unaudited)

	Nine Months Ended September 30,		
	2015		2016
Cash flows from operating activities:			
Net income	\$ 16,755		\$ 14,543
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation	4,810		6,202
Amortization and change in contingent consideration	19,946		25,986
Stock-based compensation expense	14,674		22,373
Loss on disposal of fixed assets	519		185
Provision for doubtful accounts	220		1,238
Deferred taxes	5,317		(424)
Excess tax benefit related to stock-based compensation arrangements	(5,260))	(8,824)
Changes in operating assets and liabilities:			
Accounts receivable	(7,852))	(14,102)
Prepaid expenses and other current assets	(512))	919
Other assets	2,225		(50)
Accounts payable and accrued expenses	6,953		81
Customer obligations	27,952		148,495
Other liabilities	4,088		(777)
Net cash provided by operating activities	89,835		195,845
Cash flows from investing activities:			
Purchases of property and equipment	(24,200))	(20,529)
Cash paid for acquisition of intangible assets	(9,445))	(20,777)
Net cash used in investing activities	(33,645))	(41,306)

Cash flows from financing activities:			
Proceeds from exercise of common stock options	4,695	10,705	
Proceeds from issuance of common stock under Employee Stock Purchase Plan	1,793	1,672	
Payment of contingent consideration	(3,247)	(653))
Payment for treasury stock acquired	—	(9,371))
Excess tax benefit related to stock-based compensation arrangements	5,260	8,824	
Net cash provided by financing activities	8,501	11,177	
Net increase in cash and cash equivalents	64,691	165,716	
Cash and cash equivalents at beginning of period	413,301	500,918	
Cash and cash equivalents at end of period	\$ 477,992	\$ 666,634	
Supplemental cash flow disclosure:			
Cash paid during the period for:			
Interest	\$ 2,079	\$ 1,139	
Income Taxes	822	5,216	
Noncash financing and investing activities:			
Accrued capital expenditures	371	2,882	

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

Table of Contents

(1) Summary of Business and Significant Accounting Policies

Business

WageWorks, Inc., (together with its subsidiaries, “WageWorks” or the “Company”) was incorporated in the state of Delaware in 2000. The Company is a leader in administering Consumer-Directed Benefits (“CDBs”), which empower employees to save money on taxes while also providing corporate tax advantages for employers. The Company operates as a single reportable segment on an entity level basis.

Basis of Presentation

In the opinion of the Company’s management, the unaudited interim consolidated financial statements and condensed notes have been prepared on the same basis as the audited consolidated financial statements and reflect all adjustments that, in the opinion of management, are necessary for a fair presentation of the results for the interim periods presented in accordance with accounting principles generally accepted in the United States of America (“U.S. GAAP”). The results of the interim period presented herein are not necessarily indicative of the results of future periods or annual results for the year ending December 31, 2016.

These unaudited interim consolidated financial statements and condensed notes should be read in conjunction with the December 31, 2015 audited financial statements and related notes, together with management’s discussion and analysis of financial condition and results of operations, included in the Company’s Annual Report on Form 10-K. The December 31, 2015 consolidated balance sheet, included in this interim Quarterly Report on Form 10-Q, was derived from audited financial statements. Certain prior year amounts in the consolidated statement of cash flows have been reclassified to conform to the current year’s presentation.

There have been no changes in the Company’s significant accounting policies from those that were disclosed in the Company’s audited consolidated financial statements for the fiscal year ended December 31, 2015 included in the Company’s Annual Report on Form 10-K.

Principles of Consolidation

The unaudited consolidated financial statements include the accounts of WageWorks, Inc. and its subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation.

Use of Estimates

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Significant estimates in these consolidated financial statements include allowances for doubtful accounts, estimates of future cash flows associated with assets, useful lives for depreciation and amortization, loss contingencies, expired and unredeemed products, deferred tax assets, reserve for income tax uncertainties, the assumptions used for stock-based compensation, the assumptions used for software and website development cost classification, and valuation and impairments of goodwill and long-lived assets. Actual results could differ from those estimates. In making its estimates, the Company considers the current economic and legislative environment and has considered those factors when reviewing the underlying assumptions of the estimates.

Fair Value of Financial Instruments

The Company's financial assets and liabilities are recognized or disclosed at fair value in the financial statements on a recurring basis. The carrying amount of financial instruments approximates fair value because of their short maturity. The carrying amount of the Company's variable rate debt approximates fair value.

The Company utilizes valuation techniques that maximize the use of observable inputs and minimize the use of unobservable inputs to the extent possible. The Company determines fair value based on assumptions that market participants would use in pricing an asset or liability in the principal or most advantageous market. When considering market participant assumptions in fair value measurements, the following fair value hierarchy distinguishes between observable and unobservable inputs, which are categorized in one of the following levels:

Table of Contents

• Level 1 Inputs: Unadjusted quoted prices in active markets for identical assets or liabilities accessible to the reporting entity at the measurement date.

• Level 2 Inputs: Other than quoted prices included in Level 1 inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the asset or liability.

Level 3 Inputs: Unobservable inputs for the asset or liability used to measure fair value to the extent that observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability at measurement date.

The contingent consideration payable related to the acquisition of Benefit Concepts, Inc. (“BCI”) was recorded at fair value on the acquisition date and is adjusted quarterly to fair value. The increases or decreases in the fair value of contingent consideration payable can result from changes in anticipated revenue levels and changes in assumed discount periods and rates. As the fair value measure is based on significant inputs that are not observable in the market, it is categorized as Level 3. The final contingent consideration for BCI was paid during the first quarter of 2016.

Other financial instruments not measured at fair value on the Company’s unaudited consolidated balance sheet at September 30, 2016, but which require disclosure of their fair values include: cash and cash equivalents (including restricted cash), accounts receivable, accounts payable and accrued expenses, and debt under the revolving credit facility with certain lenders. The estimated fair value of such instruments at September 30, 2016 approximates their carrying value as reported on the consolidated balance sheets. The fair value of all of these instruments are categorized as Level 2 of the fair value hierarchy, with the exception of cash, which is categorized as Level 1 due to its short term nature.

The following table provides a reconciliation between the beginning and ending balances of items measured at fair value on a recurring basis that used significant unobservable inputs (Level 3) (in thousands):

	Contingent Consideration BCI
Balance at December 31, 2015	\$ 739
Gains or losses included in earnings:	
Losses on revaluation of contingent consideration	11
Payment of contingent consideration	(750)
Balance at September 30, 2016	\$ —

The Company measures contingent consideration elements each reporting period at fair value and recognizes changes in fair value in earnings each period in the amortization and change in contingent consideration line item on the consolidated statements of income, until the contingency is resolved. Losses on revaluation of contingent consideration result from accretion charges due to the passage of time and fair value adjustments due to changes in forecasted revenue levels.

The Company recorded an immaterial charge for the change in fair value of the contingent consideration for the three months ended September 30, 2015, with no charge recorded for the three months ended September 30, 2016. The Company recorded \$0.1 million and an immaterial charge for the nine months ended September 30, 2015 and 2016, respectively, as a result of accretion charges due to the passage of time.

Recently Issued Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update No. 2014-09, Revenue from Contracts with Customers (“ASU 2014-09”) which supersedes existing accounting literature relating to how and when a company recognizes revenue. Under ASU 2014-09, a company will recognize revenue when it transfers promised goods or services to customers in an amount that reflects the consideration to which the company expects to be entitled in exchange for those goods and services. Additionally, the guidance requires improved disclosures to help users of financial statements better understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. The new standard allows for either a full retrospective with or without practical expedients or a retrospective with a cumulative catch upon adoption transition method. In July 2015, the FASB deferred the effective date for annual reporting periods beginning after December 15, 2017 (including interim reporting periods within those periods) in ASU 2015-14. Early adoption is permitted to the original effective date for periods beginning after December 15, 2016 (including interim reporting

Table of Contents

periods within those periods). The Company is in the process of determining which transition method it will use and what impact, if any, the adoption of ASU 2014-09 will have on its consolidated financial statements and related disclosures.

Subsequent to the issuance of ASU 2014-09, the FASB has issued several ASUs such as ASU 2016-08, Revenue from Contracts with Customers: Principal versus Agent Considerations (Reporting Revenue Gross versus Net), ASU 2016-10, FASB Accounting Standards Codification - Consensus of the FASB Emerging Issues Task Force, and ASU 2016-12, Revenue from Contracts with Customers: Narrow-Scope Improvements and Practical Expedients among others. These ASUs do not change the core principle of the guidance stated in ASU 2014-09, instead these amendments are intended to clarify and improve operability of certain topics included within the revenue standard. These ASUs will have the same effective date and transition requirements as ASU 2014-09. The Company is currently assessing the impact, if any, the adoption of these ASUs and ASU 2014-09 will have on its consolidated financial statements and related disclosures.

In April 2015, the FASB issued Accounting Standards Update No. 2015-05, Customer's Accounting for Fees Paid in a Cloud Computing Arrangement ("ASU 2015-05"). ASU 2015-05 provides guidance to customers about whether a cloud computing arrangement includes a software license. If a cloud computing arrangement includes a software license, then the customer should account for the software license element of the arrangement consistent with the acquisition of other software license. If a cloud computing arrangement does not include a software license, the customer should account for the arrangement as a service contract. The guidance will not change GAAP for a customer's accounting for service contracts. The Company adopted ASU 2015-05 in the first quarter of 2016. The adoption of ASU 2015-05 did not have a material impact on the consolidated financial statements and related disclosures.

In February 2016, the FASB issued Accounting Standards Update No. 2016-02, Leases, ("ASU 2016-02"). Under the new guidance, lessees will be required to recognize a lease liability and a right-of-use asset for all leases (with the exception of short-term leases) at the commencement date. The ASU is effective for fiscal years and interim periods within those years beginning after December 15, 2018, with early adoption permitted. The new standard is required to be applied with a modified retrospective approach to each prior reporting period presented with various optional practical expedients. The Company is currently assessing what impact, if any, the adoption of this ASU will have on its consolidated financial statements and related disclosures.

In March 2016, the FASB issued Accounting Standard Update No. 2016-04, Recognition of Breakage for Certain Prepaid Stored-Value Products, ("ASU 2016-04"). The new guidance creates an exception under ASC 405-20, Liabilities-Extinguishments of Liabilities, to derecognize financial liabilities related to certain prepaid stored-value products using a revenue-like breakage model. The new guidance is effective for fiscal years and interim periods within those years beginning after December 15, 2017, with early adoption permitted. This guidance can be applied either retrospectively to each period presented or as a cumulative-effect adjustment as of the date of adoption. The Company is currently assessing what impact, if any, the adoption of this ASU will have on its consolidated financial statements and related disclosures.

In March 2016, the FASB Issued Accounting Standards Update No 2016-09, Compensation-Stock Compensation: Improvements to Employee Share-Based Payment Accounting, ("ASU 2016-09"). The updated guidance changes how companies account for certain aspects of share-based payment awards to employees, including the accounting for income taxes, forfeitures, and statutory tax withholding requirements, as well as classification in the statement of cash flows. The update to the standard is effective for fiscal years and interim periods within those years beginning after December 15, 2016, with early adoption permitted. The Company is currently assessing what impact, if any, the adoption of this ASU will have on its consolidated financial statements and related disclosures.

In August 2016, the FASB issued Accounting Standards Update No. 2016-15, Statement of Cash flows: Classification of Certain Cash Receipts and Cash Payments, ("ASU 2016-15"). The update provides specific guidance on a number of cash flow classification issues including contingent consideration payments made after a business combination, proceeds from settlement of insurance claims, proceeds from settlement of corporate-owned life insurance policies, including bank-owned life insurance policies, distributions received from equity method investees, and separately identifiable cash flows and application of the predominance principle. The update to the standard is effective for fiscal years and interim period within those years beginning after December 15, 2017, with early adoption permitted. The Company is currently assessing what impact, if any, the adoption of this ASU will have on its consolidated financial statements and related disclosures.

Table of Contents

(2) Net Income per Share

The following table sets forth the computation of basic and diluted net income per share (in thousands, except per share data):

	Three Months Ended September 30, 2015		Nine months ended September 30, 2016	
Numerator for basic net income per share:				
Net income	\$7,598	\$5,894	\$16,755	\$14,543
Denominator for basic net income per share:				
Weighted-average common shares outstanding	35,880	36,605	35,733	36,312
Basic net income per share	\$0.21	\$0.16	\$0.47	\$0.40
Numerator for diluted net income per share:				
Net income	\$7,598	\$5,894	\$16,755	\$14,543
Denominator for diluted net income per share:				
Weighted-average common shares outstanding	35,880	36,605	35,733	36,312
Dilutive stock options and restricted stock units	636	849	862	733
Dilutive vested performance restricted stock units	—	—	—	33
Diluted weighted-average common shares outstanding	36,516	37,454	36,595	37,078
Diluted net income per share	\$0.21	\$0.16	\$0.46	\$0.39

Stock options and restricted stock units to purchase common stock are not included in the computation of diluted earnings per share if their effect would be anti-dilutive. There were 1.4 million and 0.4 million anti-dilutive share equivalents for the three months ended September 30, 2015 and 2016, respectively and 0.9 million and 1.1 million anti-dilutive share equivalents for the nine months ended September 30, 2015 and 2016, respectively.

(3) Intangible Assets

Acquired intangible assets at December 31, 2015 and September 30, 2016 were comprised of the following (in thousands):

	December 31, 2015			September 30, 2016		
	Gross carrying amount	Accumulated amortization	Net	Gross carrying amount	Accumulated amortization	Net
Amortizable intangible assets:						
Client contracts and broker relationships	\$124,261	\$ 47,013	\$77,248	\$138,319	\$ 56,028	\$82,291
Trade names	3,880	2,405	1,475	3,880	2,916	964
Technology	13,846	11,039	2,807	13,846	11,635	2,211
Noncompete agreements	2,232	1,870	362	2,232	1,923	309
Favorable lease	1,136	412	724	1,136	485	651
Total	\$145,355	\$ 62,739	\$82,616	\$159,413	\$ 72,987	\$86,426

Included in the gross carrying amount in client contracts and broker relationships intangible assets as of September 30, 2016 is the addition related to the channel partner arrangement with Ceridian Corporation (“Ceridian”). Amortization expense of intangible assets totaled \$3.9 million and \$4.1 million for the three months ended September 30, 2015 and 2016, respectively. Amortization expense of intangible assets totaled \$11.5 million and \$17.0 million for the nine months ended September 30, 2015 and 2016, respectively. These costs are included in amortization and change in contingent consideration in the accompanying consolidated statements of income.

Table of Contents

The estimated amortization expense in future periods at September 30, 2016 is as follows (in thousands):

Remainder of 2016	\$4,045
2017	15,790
2018	15,164
2019	14,604
2020	12,620
Thereafter	24,203
Total	\$86,426

(4) Accounts Receivable

Accounts receivable at December 31, 2015 and September 30, 2016 were comprised of the following (in thousands):

	December 31, 2015	September 30, 2016
Trade receivables	\$ 37,999	\$ 50,599
Unpaid amounts for benefit services	35,343	36,656
	73,342	87,255
Less allowance for doubtful accounts	(1,071)	(2,120)
Accounts receivable, net	\$ 72,271	\$ 85,135

(5) Property and Equipment

Property and equipment at December 31, 2015 and September 30, 2016 were comprised of the following (in thousands):

	December 31, 2015	September 30, 2016
Computers and equipment	\$ 14,461	\$ 16,985
Software and software development costs	92,898	105,056
Furniture and fixtures	5,083	6,263
Leasehold improvements	13,594	18,169
	\$ 126,036	\$ 146,473
Less accumulated depreciation and amortization	(78,081)	(91,022)
Property and equipment, net	\$ 47,955	\$ 55,451

In the three months ended September 30, 2015 and 2016, the Company capitalized software development costs of \$3.8 million and \$4.0 million, respectively. In the nine months ended September 30, 2015 and 2016, the Company capitalized software development costs of \$12.4 million and \$11.0 million, respectively. In the three months ended September 30, 2015 and 2016 the Company amortized \$3.0 million and \$2.6 million of capitalized software development costs, respectively. In the nine months ended September 30, 2015 and 2016, the Company amortized \$8.3 million and \$8.9 million of capitalized software development costs, respectively. These costs are included in amortization and change in contingent consideration in the accompanying consolidated statements of income. At September 30, 2016, the unamortized software development costs included in property and equipment in the accompanying consolidated balance sheets were \$29.2 million.

Total depreciation expense, including amortization of capitalized software development costs, for the three months ended September 30, 2015 and 2016 was \$4.7 million and \$5.2 million, respectively and \$13.1 million and \$15.3 million for the nine months ended September 30, 2015 and 2016, respectively.

(6) Accounts Payable and Accrued Expenses

10

Table of Contents

Accounts payable and accrued expenses at December 31, 2015 and September 30, 2016 were comprised of the following (in thousands):

	December 31, 2015	September 30, 2016
Accounts payable	\$ 2,542	\$ 2,860
Payable to benefit providers and transit agencies	23,169	26,634
Accrued payables	11,198	12,751
Accrued compensation and related benefits	18,538	20,435
Other accrued expenses	2,891	2,926
Deferred revenue	2,203	3,571
Accounts payable and accrued expenses	\$ 60,541	\$ 69,177

(7) Long-term debt

On June 5, 2015, the Company entered into an Amended and Restated Credit Agreement ("Credit Agreement") with certain lenders, including MUFG Union Bank, N.A., as administrative agent. With a \$15.0 million subfacility for the issuance of letters of credit, the amendment provides for a \$150.0 million revolving credit facility, and an increase option permitting the Company to arrange with existing lenders and/or new lenders to provide up to an aggregate of \$100.0 million in additional commitments. The amendment extended the term of the credit facility to June 5, 2020 and reduced the margin added to the London Interbank Offered Rate ("LIBOR") to a range of 125 to 175 basis points.

On August 1, 2016, the Company entered into a first amendment to the Credit Agreement increasing the credit limit of the revolving credit facility to \$250.0 million. This amendment did not change the subfacility limit, terms, or maturity date of the credit facility which remained at June 5, 2020. The interest rate applicable to the revolving credit facility as of September 30, 2016 was 1.77%. In connection with this amendment, the Company incurred fees of approximately \$0.2 million, which are being amortized over the term of the amendment. The fees incurred are classified as a direct deduction from the long-term debt line item in the consolidated balance sheets. As of September 30, 2016, the Company had \$79.6 million outstanding under the revolving credit facility.

Amounts borrowed, outstanding letters of credit, and amounts available to borrow were as follows (in thousands):

	December 31, 2015	September 30, 2016
Amounts borrowed	\$ 79,600	\$ 79,600
Outstanding letters of credit	2,700	2,700
Amounts available to borrow (1)	67,700	167,700

(1) Amounts available to borrow at December 31, 2015 excludes \$100 million increase option

As collateral, the Company's obligations are secured by substantially all of the Company's assets. All of the Company's material existing and future subsidiaries are required to guarantee the Company's obligations under the credit facility. Such guarantees by existing and future material subsidiaries are and will be secured by substantially all of the property of such material subsidiaries.

The credit facility contains customary affirmative and negative covenants and also has financial covenants relating to a liquidity ratio, a consolidated leverage ratio, and an interest coverage ratio. The Company is obligated to pay

customary commitment fees and letter of credit fees for a facility of this size and type. The Company is currently in compliance with all financial and non-financial covenants under the credit facility.

The credit facility contains customary events of default including, among others, payment defaults, covenant defaults, inaccuracy of representations and warranties, cross-defaults to other material indebtedness, judgment defaults, a change of control default and bankruptcy, and insolvency defaults. Under certain circumstances, a default interest rate will apply on all obligations during the existence of an event of default under the loan agreement at a per annum rate of interest equal to 2.00%

Table of Contents

above the applicable interest rate. Upon an event of default, the lenders may terminate the commitments, declare the outstanding obligations payable by the Company to be immediately due and payable, and exercise other rights and remedies provided for under the credit facility.

(8) Organizational Efficiency Plan

During the second quarter of 2015, the Company integrated operations and consolidated certain positions resulting in employee headcount reductions. The Company continually evaluates ways to improve business processes to ensure that operations align with its strategy and vision for the future. In the three and nine months ended September 30, 2015, the Company recorded a \$0.1 million credit related to unused outplacement services, and a charge of \$2.0 million for employee termination costs primarily related to severance costs, respectively. In the three and nine months ended September 30, 2016, the Company recognized an immaterial charge and a charge of \$0.3 million, respectively, in the employee termination and other charges expense line item, primarily due to severance and other costs associated with the closure of an office location. The Company recorded these severance costs within accrued expenses in the accompanying consolidated balance sheets.

Changes in the Company's accrued liabilities for workforce reduction costs in the nine months ended September 30, 2016 were as follows (in thousands):

	Amount
Beginning balance as of December 31, 2015	\$ 183
Employee termination and other charges	263
Cash paid	(412)
Ending balance as of September 30, 2016	\$ 34

(9) Employee Benefit Plans

Employee Stock Option Plan

The Company's stock option program is a long-term retention program that is intended to attract, retain, and provide incentives for talented employees, officers, and directors and to align stockholder and employee interests.

The following table summarizes the weighted-average fair value of stock options granted:

	Three Months Ended September 30,		Nine months Ended September 30,	
	2015	2016	2015	2016
Stock options granted (in thousands)	413	27	464	804
Weighted-average fair value at date of grant	\$18.70	\$22.86	\$19.09	\$18.30

Stock option activity for the nine months ended September 30, 2016 was as follows (shares in thousands):

Shares	Weighted-average exercise price	Remaining	Aggregate
--------	---------------------------------	-----------	-----------

Edgar Filing: WAGEWORKS, INC. - Form 10-Q

			contractual term (in years)	intrinsic value (in thousands)
Outstanding at December 31, 2015	3,037	\$ 25.18	6.41	\$ 65,229
Granted	804	48.10		
Exercised	(673)	15.90		
Forfeited	(79)	46.24		
Outstanding as of September 30, 2016	3,089	\$ 32.62	7.06	\$ 87,400
Vested and expected to vest at September 30, 2016	2,951	\$ 31.99	6.98	\$ 85,367
Exercisable at September 30, 2016	1,638	\$ 20.63	5.48	\$ 66,006

Table of Contents

As of September 30, 2016, there was \$23.3 million of total unrecognized compensation cost related to unvested stock options which are expected to vest. The cost is expected to be recognized over a weighted-average period of approximately 2.8 years as of September 30, 2016.

The Company calculated the fair value of each option award on the date of grant using the Black-Scholes option pricing model with the following weighted-average assumptions:

	Three Months Ended September 30, 2015		Nine Months Ended September 30, 2016	
Expected volatility	43.43 %	41.87 %	43.49 %	42.69 %
Risk-free interest rate	1.55 %	1.07 %	1.55 %	1.17 %
Expected term (in years)	4.74	4.87	4.74	4.87
Dividend yield	— %	— %	— %	— %

Stock-based compensation cost is measured at the grant date based on the fair value of the award. The determination of the fair value of stock-based awards on the date of grant using an option pricing model is affected by the Company's stock price as well as assumptions regarding a number of complex and subjective variables. Expected volatility is determined using weighted-average volatility of peer publicly traded companies as well as the Company's own historical volatility. The Company expects that it will increase weighting of its own historical data in future periods, as that history grows over time. The risk-free interest rate is determined by using published zero coupon rates on treasury notes for each grant date given the expected term on the options. The dividend yield of zero is based on the fact that the Company expects to invest cash in operations and has not paid cash dividends on its common stock. The Company estimates the expected term based on historical experience, giving consideration to the contractual terms of the stock-based awards, vesting schedules, and expectations of future employee behavior such as exercises and forfeitures.

Restricted Stock Units

The Company grants restricted stock units to certain employees, officers, and directors under the 2010 Equity Incentive Plan. Restricted stock units vest upon performance-based, market-based, or service-based criteria.

Performance-based restricted stock units vest based on the satisfaction of specific performance criteria. At each vesting date, the holder of the award is issued shares of the Company's common stock. Compensation expense from these awards is equal to the fair market value of the Company's common stock on the date of grant and is recognized over the remaining service period based on the probable outcome of achievement of the financial metrics. Management's estimate of the number of shares expected to vest is based on the anticipated achievement of the specified performance criteria.

Market-based performance restricted stock units are granted such that they vest upon the achievement of certain per share price targets of the Company's common stock during a specified performance period. The fair market values of market-based performance restricted stock units are determined using the Monte Carlo simulation method. The Monte Carlo simulation method is subject to variability as several factors utilized must be estimated including the future daily stock price of the Company's common stock over the specified performance period, the Company's stock price volatility and risk-free interest rate. The amount of compensation expense is equal to the per share fair value calculated under the Monte Carlo simulation multiplied by the number of market-based performance restricted stock units granted, recognized over the specified performance period.

Generally, service-based restricted stock units vest over a four year period in equal annual installments commencing upon the first anniversary of the grant date.

In the first quarter of 2015 and 2016, the Company granted a total of 140,000 and 263,000, respectively, of performance-based restricted stock units to certain executive officers. Performance-based restricted stock units are typically granted such that they vest upon the achievement of certain revenue growth rates and other financial metrics during a specified performance period for which participants have the ability to receive up to 150% or 200% of the target number of shares originally granted, depending on terms of the grant agreement.

Table of Contents

The restricted stock units will be eligible to vest based on the Company's achievement against an average annual earnings before interest, taxes, depreciation, and amortization ("EBITDA") margin target equal to or greater than 22% and compound revenue growth target for the specified performance period.

The following table describes the levels of revenue growth target for the specified performance period for the restricted stock units granted in 2016 to vest:

Achievement of Revenue Growth Objective	Percentage of Restricted Stock Unit Vesting
20% and Greater	200% will vest
Between 15% but less than 20%	Between 100% and 200% will vest
Between 10% but less than 15%	Between 50% and 100% will vest
Below 10%	None will vest

Stock-based compensation expense related to restricted stock units was \$3.4 million and \$4.8 million for the three months ended September 30, 2015 and 2016, respectively and \$9.0 million and \$14.8 million for the nine months ended September 30, 2015 and 2016, respectively. Total unrecorded stock-based compensation cost at September 30, 2016 associated with restricted stock units was \$33.5 million, which is expected to be recognized over a weighted-average period of 1.7 years.

The following table summarizes information about restricted stock units issued to officers, directors and employees under the 2010 Equity Incentive Plan (shares in thousands):

	Shares	Weighted-Average Grant Date Fair Value
Unvested at December 31, 2015	763	\$ 44.83
Granted (1)	502	39.22
Vested (2)	(344)	21.62
Forfeited	(17)	51.57
Unvested at September 30, 2016	904	\$ 50.41

Includes additional shares granted as specified financial metrics for the performance-based restricted stock units, (1) granted to certain executives in 2013, during the performance period of January 1, 2013 through December 31, 2015 were met, resulting in actual shares vesting at 150% of the target number of shares originally granted.

(2) Includes 264,000 shares vested from performance-based restricted stock units granted to certain executives in 2013 representing 150% of the target number of shares originally granted.

Stock-based compensation is classified in the consolidated statements of income in the same expense line items as cash compensation. Amounts recorded as expense in the consolidated statements of income were as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2015	2016	2015	2016
Cost of revenue	\$977	\$1,581	\$2,676	\$4,549
Technology and development	391	671	733	1,815
Sales and marketing	660	789	1,992	2,287
General and administrative	3,397	4,490	9,273	13,722

Total	\$5,425	\$7,531	\$14,674	\$22,373
-------	---------	---------	----------	----------

(10) Income Taxes

The income tax provision for the three months ended September 30, 2015 and 2016 was \$4.8 million and \$3.2 million, respectively and the income tax provision for the nine months ended September 30, 2015 and 2016 was \$11.2 million and \$8.5 million respectively. The Company's effective tax rate was 38.9% and 35.3% for the three months ended September 30, 2015

Table of Contents

and 2016 and 40.2% and 36.9% for the nine months ended September 30, 2015 and 2016, respectively. The Company provides for income taxes using an asset and liability approach, under which deferred income taxes are provided based upon enacted tax laws and rates applicable to periods in which the taxes become payable.

The Company is subject to income taxes in the U.S. federal and various state jurisdictions. Presently, the Company is under audit in New York State. There are no other income tax examinations ongoing in the jurisdictions where the Company operates.

As of September 30, 2016, the Company remains in a net deferred tax asset position. The realization of the Company's deferred tax assets depends primarily on its ability to generate sufficient U.S. taxable income in future periods. The amount of deferred tax assets considered realizable may increase or decrease in subsequent quarters as management reevaluates the underlying basis for the estimates of future domestic taxable income.

(11) Commitments and Contingencies

(a) Operating Leases

The Company leases office space and equipment under noncancelable operating leases with various expiration dates through 2023. Future minimum lease payments under noncancelable operating leases, excluding the contractual sublease income of \$11.8 million, are as follows (in thousands):

	As of September 30, 2016
Remainder of 2016	\$ 2,054
2017	8,292
2018	7,947
2019	7,921
2020	7,717
Thereafter	13,662
Total future minimum lease payments	\$ 47,593

Rent expense for both the three months ended September 30, 2015 and 2016 was \$1.9 million. Rent expense for the nine months ended September 30, 2015 and 2016 was \$5.9 million and \$5.2 million, respectively. Sublease income for the three and nine months ended September 30, 2016 was \$0.3 million and there was no sublease income recognized for the same periods in 2015. As of September 30, 2016, the Company has an immaterial amount of future minimum lease payments under capital leases, not included in the table above. The Company has no future minimum lease payments under capital leases extending beyond 2016.

(b) Legal Matters

The Company is involved from time to time in claims that arise in the normal course of its business. The Company is not presently subject to any material litigation nor, to management's knowledge, is any litigation threatened against the Company that collectively is expected to have a material adverse effect on the Company's cash flows, financial condition, or results of operations.

(12) Stockholders' Equity

Share Repurchase Program

On August 6, 2015, the Company's Board of Directors authorized a \$100 million stock repurchase program which commenced immediately and does not have an expiration date. Repurchases made under this program may be made in the open market as the Company deems appropriate and market conditions allow. The Company repurchased 226,170 shares of common stock during the nine months ended September 30, 2016 for a total cost of \$9.4 million, or an average price of \$41.43 per share. There were no shares of common stock repurchased during the three months ended September 30, 2016. As of September 30, 2016, the Company had \$85.6 million available for future purchases under the stock repurchase program.

Table of Contents

(13) Subsequent events

On November 1, 2016, the Company entered into an Asset Purchase Agreement with Automatic Data Processing Inc. ("ADP"), a leading global provider of Human Capital Management solutions, to acquire ADP's Consumer Health Spending Account and Consolidated Omnibus Budget Reconciliation Act ("COBRA") businesses for \$235.0 million in cash.

In connection with the planned acquisition, the Company has amended the Credit Agreement to increase the size of its revolving credit facility to \$250.0 million. The acquisition is expected to close by the end of November 2016, subject to reasonable customary conditions.

Table of Contents

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 appearing elsewhere in this Quarterly Report on Form 10-Q. The following discussion and analysis contains forward-looking statements that involve risks and uncertainties, as well as assumptions that, if they never materialize or prove incorrect, could cause our results to differ materially from those expressed or implied by such forward-looking statements. Statements that are not purely historical are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended (the "Securities Act"), and Section 21E of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Forward-looking statements are often identified by the use of words such as, but not limited to, "anticipate," "believe," "can," "continue," "could," "estimate," "expect," "intend," "may," "plan," "project," "seek," "should," "target," "will," and "would," or variations intended to identify forward-looking statements. Such statements include, but are not limited to, statements concerning market opportunity, our future financial and operating results, investment strategy, sales and marketing strategy, management's plans, beliefs and objectives for future operations, technology and development, economic and industry trends, expectations about seasonality, opportunity for channel partnerships and acquisition activities and our integration thereof, use of non-GAAP financial measures, our future operating expenses, anticipated income tax rates, capital expenditures, cash flows and liquidity. These statements are based on the beliefs and assumptions of our management based on information currently available to us. Such forward-looking statements are subject to risks, uncertainties and other important factors that could cause actual results and the timing of certain events to differ materially from future results expressed or implied by such forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those identified in Part I, Item 1A, "Risk Factors", of our Annual Report on Form 10-K for the year ended December 31, 2015. Furthermore, such forward-looking statements speak only as of the date of this report. Except as required by law, we undertake no obligation to update any forward-looking statements to reflect events or circumstances after the date of such events.

Overview

We are a leader in administering Consumer-Directed Benefits, or CDBs, which empower employees to save money on taxes and provide corporate tax advantages for employers. We are solely dedicated to administering CDBs, including pre-tax spending accounts such as Health Savings Accounts, or HSAs, health and dependent care Flexible Spending Accounts, or FSAs, Health Reimbursement Arrangements, or HRAs, as well as Commuter Benefit Services, including transit and parking programs, wellness programs, Consolidated Omnibus Budget Reconciliation Act, or COBRA, and other employee benefits.

We deliver our CDB programs through a highly scalable delivery model that employer clients and their employee participants may access through a standard web browser on any internet-enabled device, including computers, smart phones, and other mobile devices such as tablet computers. Our on-demand delivery model eliminates the need for our employer clients to install and maintain hardware and software in order to support CDB programs and enables us to rapidly implement product enhancements across our entire user base.

Our CDB programs assist employees and their families in saving money by using pre-tax dollars to pay for certain portions of their healthcare, dependent care, and commuter expenses. Employers financially benefit from our programs through reduced payroll taxes, the benefits of which are realized even after factoring in our fees. Under our FSA, HSA, and commuter programs, employee participants contribute funds from their pre-tax income to pay for qualified out-of-pocket healthcare expenses, not fully covered by insurance, such as co-pays, deductibles, and over-the-counter medical products or for commuting costs.

We price our services based on the estimated number and types of claims, whether payment processing and client support activities will be provided within or outside of the United States, the estimated number of calls to our

customer support center, and any specific client requirements. In addition, we derive a portion of our revenues from interchange fees that we receive when employee participants use the prepaid debit cards we provide to them for healthcare and commuter expenses.

In September 2015, we entered into our second channel partner arrangement with Ceridian Corporation, or Ceridian, to transition their COBRA and direct bill portfolio to WageWorks. This relationship also allows Ceridian to resell the Company's COBRA and direct bill services to their new and existing clients, in addition to the full suite of healthcare and commuter products they have been selling. Pursuant to the arrangement, transition of the portfolio was completed by the second quarter of 2016.

In March, 2016, we were selected by the United States Office of Personnel Management, or OPM, to administer its Federal Flexible Spending Account Program, or FSAFEDS. This new relationship provides eligible Federal employees access to our advanced technology platform and premium service capabilities. Service to existing participants has started and transition of all

Table of Contents

participants was completed during the third quarter of 2016. In addition, the United States Postal Service will join the OPM contract in the first quarter of 2017.

On November 1, 2016, we entered into an Asset Purchase Agreement with Automatic Data Processing Inc., or ADP, a leading global provider of Human Capital Management solutions, to acquire ADP's Consumer Health Spending Account, or CHSA, and COBRA businesses for \$235.0 million in cash.

In connection with the planned acquisition, we amended the Credit Agreement to increase the size of our revolving credit facility to \$250.0 million. The acquisition is expected to close by the end of November 2016, subject to reasonable customary conditions.

Critical Accounting Policies and Significant Management Estimates

There have been no material changes to our critical accounting policies and estimates during the nine months ended September 30, 2016, as compared to the critical accounting policies and estimates disclosed in the "Management's Discussion and Analysis of Financial Condition and Results of Operations" included in our Annual Report on Form 10-K for the year ended December 31, 2015.

Results of Operations

Comparison of the Three and Nine Months Ended September 30, 2015 and 2016

Revenue

	Three Months Ended September 30,		Change from	Nine Months Ended September 30,		Change from	
	2015	2016	prior year	2015	2016	prior year	
Revenues:	(In thousands, unaudited)			(In thousands, unaudited)			
Healthcare	\$42,204	\$48,478	15 %	\$133,307	\$146,918	10 %	
Commuter	16,003	17,580	10 %	47,928	52,339	9 %	
COBRA	12,229	18,670	53 %	37,112	51,955	40 %	
Other	12,724	4,196	(67) %	32,866	12,439	(62) %	
Total revenues	\$83,160	\$88,924	7 %	\$251,213	\$263,651	5 %	

Healthcare Revenue

We derive our healthcare revenue from the service fees paid by our employer clients for the administration services we provide in connection with their employee participants' FSAs, HRAs, and HSAs. We also earn interchange revenue paid by financial institutions related to transaction fees on debit cards used by employee participants in connection with all of our healthcare programs and through our wholesale card program and revenue from self-service plan kits called Premium Only Plan kits, or POP revenue.

The \$6.3 million increase in healthcare revenue for the three months ended September 30, 2016, as compared to the same period in 2015, was driven primarily by the revenue generated from administering FSAFEDS, an increase in

FSA, HSA, and HRA revenue due to the addition of other new clients and growth in new employee participation in the programs, and increases in interchange fee revenue.

The \$13.6 million increase in healthcare revenue for the nine months ended September 30, 2016, as compared to the same period in 2015, was due primarily to the revenue generated from administering FSAFEDS, an increase in FSA, HSA, and HRA revenues due to the addition of other new clients and growth in new employee participation in the programs, and increases in interchange fee revenue.

Commuter Revenue

Table of Contents

We derive our commuter revenue from monthly service fees paid by our employer clients, interchange revenue paid by financial institutions related to transaction fees on debit cards used by employee participants in connection with our commuter solutions, and commissions from the sale of transit passes used in our commuter solutions which we purchase from various transit agencies on behalf of employee participants.

The \$1.6 million increase in commuter revenue for the three months ended September 30, 2016, as compared to the same period in 2015, was driven primarily by the increase in employee participation as a result of the maximum pre-tax monthly benefit for transit and vanpooling increase from \$130 in 2015 to \$255 in 2016. Other increases in commuter revenue were due to the addition of new clients, growth in employee participation in other Commuter programs, and higher vendor commission revenue from growth in our Commuter programs.

The \$4.4 million increase in commuter revenue for the nine months ended September 30, 2016, as compared to the same period in 2015, was driven primarily by the increase in employee participation as a result of the increase in maximum pre-tax monthly benefit for transit and vanpooling, as mentioned above, as well as the addition of new clients and growth in employee participation in other Commuter programs. Our commuter revenue was further increased by higher interchange revenue as compared to the same period in 2015.

COBRA Revenue

COBRA revenue is derived from administration services we provide to employer clients for continuation of coverage for participants who are no longer eligible for the employer's health benefits, such as medical, dental, and vision, and for the continued administration of the employee participants' HRAs and certain healthcare FSAs.

The \$6.4 million and \$14.8 million increase in COBRA revenue for the three and nine months ended September 30, 2016, respectively, as compared to the same period in 2015 was due primarily to the transition of the portfolio under the channel partner arrangement with Ceridian as well as addition of new clients to the program.

Other Revenue

Other revenue includes enrollment and eligibility services, employee account administration (i.e., tuition and health club reimbursements), and project-related professional fees. We also derived other revenue from administrative services we provided to a significant customer to operate their health insurance exchange business which includes enrollment, billing, customer service, and payment processing services. In September 2015, the aforementioned customer and we mutually agreed to terminate the relationship. As a result, revenues related to administrative services provided to this individual customer are not expected to continue to be a significant portion of other revenue beyond 2015.

The \$8.5 million and \$20.4 million decrease in other revenue for the three and nine months ended September 30, 2016, respectively, as compared to the same period in 2015, was driven primarily by a decrease in revenue as a result of the termination of the relationship with a significant customer in the health insurance exchange business, partially offset by other increases in revenue for the three and nine months ended September 30, 2016, respectively.

Cost of Revenues

Three Months Ended September 30,		Change from prior year	Nine Months Ended September 30,		Change from prior year
2015	2016		2015	2016	

Edgar Filing: WAGEWORKS, INC. - Form 10-Q

	(In thousands, unaudited)				(In thousands, unaudited)			
Cost of revenues (excluding amortization of internal use software)	\$26,364	\$30,566	16	%	\$88,210	\$90,237	2	%
Percent of revenue	32	%	34	%	35	%	34	%

The primary component of cost of revenues is expenses related to our claims processing, product support, and customer service personnel. Cost of revenues also includes outsourced and temporary labor costs, check/ACH payment processing services, debit card processing services, shipping and handling costs for cards and passes, and employee participant communications costs.

Table of Contents

The \$4.2 million increase in cost of revenues for the three months ended September 30, 2016, as compared to the same period in 2015, was due primarily to an increase in expenses related to increases in headcount, temporary help, and outsourced services in the third quarter of 2016 to administer FSAFEDS and service new clients transitioned under the channel partner arrangement with Ceridian. Cost of revenues was further increased by higher stock-based compensation expense due primarily to new grants of restricted stock units, performance-based restricted stock units, and stock options. The increases were offset by a decrease in printing and postage related to customer support, as a result of termination of the relationship with a significant customer in the health insurance exchange business.

The \$2.0 million increase in cost of revenues for the nine months ended September 30, 2016, as compared to the same period in 2015, was due primarily to an increase in stock-based compensation expense as a result of new grants of restricted stock units, performance-based restricted stock units, and stock options. The increase was further driven by increase in salaries and personnel-related costs, temporary help, and consulting services expenses to support an increase in customer base from Federal agencies and Ceridian. The increases were partially offset by lowered printing and postage related to customer support as a result of the termination of the relationship with a significant customer in the health insurance exchange business.

As we grow organically and through portfolio purchases, acquisitions, and channel partner arrangements, we expect our cost of revenues to increase in dollar amount to support increased employer client and employee participant levels. We also expect these costs to increase as a percentage of revenues in the remainder of 2016, as we service open enrollment for Federal agencies as well as the majority of our existing customers. Prior to migrating to our proprietary technology platforms, new portfolios often operate with higher service delivery costs that will result in increased cost of revenues until we are able to complete the migration process, which typically occurs over the 12 to 24 months period following the closing of the portfolio purchase or acquisition.

Technology and Development

	Three Months Ended September 30,		Change from prior year	Nine Months Ended September 30,		Change from prior year
	2015	2016		2015	2016	
	(In thousands, unaudited)			(In thousands, unaudited)		
Technology and development	\$11,560	\$11,668	1 %	\$33,928	\$32,656	(4)%
Percent of revenue	14	% 13	%	14	% 12	%

Technology and development expenses include personnel and related expenses for our technology operations and development personnel as well as outsourced programming services, the costs of operating our on-demand technology infrastructure, depreciation of equipment, and software licensing expenses. During the planning and post-implementation phases of development, we expense, as incurred, all internal use software and website development expenses associated with our proprietary scalable delivery model. Expenses associated with the platform content or the repair or maintenance of the existing platforms are expensed as incurred.

The \$0.1 million increase in technology and development expenses for the three months ended September 30, 2016, as compared to the same period in 2015, was due primarily to an increase in salaries and personnel-related expense to support the increase in customer base from Ceridian, and an increase in stock-based compensation expense as a result of new grants of restricted stock units, performance-based restricted stock units, and stock options. The increases were offset by decreases in temporary help and consulting services expenses, as a result of the termination of a significant customer relationship in the health insurance exchange business in the third quarter of 2015.

The \$1.3 million decrease in technology and development expenses for the nine months ended September 30, 2016, as compared to the same period in 2015, was due primarily to decreases in temporary help, consulting and outsourced services expenses as a result of the termination of a significant customer relationship in the health insurance exchange business in the third quarter of 2015, offset by an increase in salaries and personnel-related expenses to support the increase in customer base from Ceridian and an increase in stock-based compensation expense as mentioned above.

We intend to continue enhancing the functionality of our software platform as part of our continuous effort to improve our employer client and employee participant experience and to maintain and enhance our control and compliance environment. The timing of development and enhancement projects, including the nature of expenditures as well as the phase of the project that could require capitalization or expense treatment, will significantly affect our technology and development expense both in dollar amount and as a percentage of revenues.

Table of Contents

Sales and Marketing

	Three Months Ended September 30,		Change from prior year		Nine Months Ended September 30,		Change from prior year
	2015	2016			2015	2016	
	(In thousands, unaudited)				(In thousands, unaudited)		
Sales and marketing	\$12,824	\$14,012	9 %		\$38,445	\$42,317	10 %
Percent of revenue	15	% 16	%		15	% 16	%

Sales and marketing expenses consist primarily of personnel and related expenses for our sales, client services, and marketing staff, including sales commissions for our direct sales force and external agent/broker commission expense, as well as communication, promotional, public relations, and other marketing expenses.

The \$1.2 million increase in sales and marketing expense for the three months ended September 30, 2016, as compared to the same period in 2015, was due primarily to salaries and personnel-related, temporary help, consulting service, printing, and advertising expenses to support the increase in our client base through our broker relationships and ongoing promotional marketing initiatives. The expense was further increased by stock-based compensation expense as a result of new grants of restricted stock units, performance-based restricted stock units, and stock options. The increases were offset by a decrease in outside commission expenses due to the termination of our relationship with certain brokers.

The \$3.9 million increase in sales and marketing expense for the nine months ended September 30, 2016, as compared to the same period in 2015, was due primarily to salaries and personnel-related, temporary help, consulting service, printing, and advertising expenses to support the increase in our client base through our broker relationships and ongoing promotional marketing initiatives, and an increase in stock-based compensation expense as mentioned above. The increases were offset by a decrease in outside commission expenses due to the termination of our relationship with certain brokers.

We continue to invest in sales, client services, and marketing by hiring additional personnel and continuing to build our broker and channel relationships. We will also promote our brand through a variety of marketing and public relations activities. As a result, we expect our sales and marketing expenses to increase in dollar amount in future periods.

General and Administrative

	Three Months Ended September 30,		Change from prior year		Nine Months Ended September 30,		Change from prior year
	2015	2016			2015	2016	
	(In thousands, unaudited)				(In thousands, unaudited)		
General and administrative	\$12,875	\$16,130	25 %		\$39,559	\$47,875	21 %
Percent of revenue	16	% 18	%		16	% 18	%

General and administrative expenses include personnel and related expenses and professional fees incurred by our executive, finance, legal, human resources, and facilities departments.

The \$3.3 million and \$8.3 million increases in general and administrative expenses for the three and nine months ended September 30, 2016, respectively, as compared to the same periods in 2015, were due primarily to an increase of stock-based compensation expense as a result of a reassessment of performance targets for performance-based restricted stock units based on updated forecasts of revenue growth, given addition of channel partners and significant customer wins, and new grants of stock awards. The expense was further increased by salaries and personnel related, depreciation, and software related expense.

As we continue to grow, we expect our general and administrative expenses to continue to increase in absolute dollars as we expand general and administrative headcount to support our continued growth.

Amortization and Change in Contingent Consideration

	Three Months Ended September 30,		Change from	Nine Months Ended September 30,		Change from
	2015	2016	prior year	2015	2016	prior year
	(In thousands, unaudited)			(In thousands, unaudited)		
Amortization and change in contingent consideration	\$6,935	\$6,944	-%	\$19,946	\$26,084	31 %

Table of Contents

Our amortization and change in contingent consideration consists of three components: amortization of internal use software, amortization of acquired intangible assets, and change in contingent consideration. We capitalize our software development costs related to the development and enhancement of our business solutions. When the technology is available for its intended use, the capitalized costs are amortized over the technology's estimated useful life, which is generally four years. Acquisition-related intangible assets are also amortized over their estimated useful lives.

Amortization and contingent consideration expense for the three months ended September 30, 2016 remained flat compared to the same period in 2015 as a result of an increase in amortization from additions to acquired intangible assets from the channel partner arrangement with Ceridian, offset by decrease from the termination of a significant customer relationship in the health insurance exchange business.

The \$6.1 million increase in the amortization and change in contingent consideration for the nine months ended September 30, 2016, as compared to the same period in 2015, was driven primarily by a \$3.8 million increase in amortization as a result of a change in the estimated useful life of intangible assets, triggered in the second quarter of 2016, related to the termination of a significant customer relationship in the health insurance exchange business. The increase was further driven by a \$1.8 million increase in amortization as a result of additions to acquired intangible assets from the channel partner arrangement with Ceridian and the CONEXIS acquisition. The remainder of the increase was due to additions to internally developed software.

Employee Termination and Other Charges

Three Months Ended September 30,			Change from prior year	Nine months Ended September 30,			Change from prior year
2015	2016			2015	2016		
(In thousands, unaudited)				(In thousands, unaudited)			
Employee termination and other charges			\$ (112) \$ 162 (245)%	\$ 1,968 \$ 475 (76)%			

The \$0.3 million increase in employee termination and other charges for three months ended September 30, 2016, as compared to the same period in 2015, was mainly due to costs associated with the planned acquisition of ADP's CHSA and COBRA businesses, and an additional cost associated with the closure of an office location.

For the nine months ended September 30, 2015 we incurred a \$2.0 million expense in employee termination and other charges due to an organizational efficiency plan. For the nine months ended September 30, 2016, we recognized charges of \$0.4 million, primarily due to severance and other costs associated with the closure of an office location. We also recognized costs associated with the planned acquisition of of ADP's CHSA and COBRA businesses.

Other Income (Expense)

Three Months	Nine Months
--------------	-------------

	Ended September 30, 2015		Ended September 30, 2016	
	(In thousands, unaudited)		(In thousands, unaudited)	
Interest income	\$66	\$117	\$85	\$300
Interest expense	(339)	(465)	(1,523)	(1,279)
Other income	(8)	22	280	24

The \$0.1 million increase in interest expense for the three months ended September 30, 2016, as compared to the same period in 2015, was due primarily to an amendment to the credit facility entered into in August 2016 resulting in a higher credit limit. The \$0.2 million decrease in interest expense for the nine months ended September 30, 2016, as compared to the same period in 2015, was due primarily to a decrease in the interest rate for our revolving credit facility with MUFG Union Bank, N.A from an average of 2.12% in 2015 to 1.69% in 2016.

Income Taxes

Table of Contents

Three Months Ended September 30,		Nine Months Ended September 30,	
2015	2016	2015	2016
(In thousands, unaudited)		(In thousands, unaudited)	
Income tax provision			
\$(4,835)		\$(3,222)	
		\$(11,244)	
		\$(8,509)	

Our provision for income taxes decreased from \$4.8 million for the third quarter of 2015 to \$3.2 million for the third quarter of 2016 and \$11.2 million for the nine months ended September 30, 2015 to \$8.5 million for the nine months ended September 30, 2016 due primarily to decrease in income before income taxes and the effective tax rate.

Liquidity and Capital Resources

At September 30, 2016, our principal sources of liquidity were cash and cash equivalents totaling \$666.6 million comprised primarily of funding by clients of amounts to be paid on behalf of employee participants as well as other cash flows from operating activities. For the nine months ended September 30, 2016 our cash flow from operating activities provided \$195.8 million and at September 30, 2016, we had \$167.7 million of borrowing capacity available under our revolving credit facility.

We believe that our existing cash and cash equivalents and expected cash flow from operations will be sufficient to meet our working capital, debt, capital expenditures, and stock repurchase needs, as well as anticipated cash requirements for potential future portfolio purchases, over at least the next 12 months. We have historically been able to fulfill our obligations as incurred and expect to continue to fulfill our obligations in the future. Our expectation is based on our current and anticipated client retention rates and our continuing funding model in which the vast majority of our enterprise clients provide us with prefunds as more fully described below under “—Prefunds.” To the extent these current and anticipated future sources of liquidity are insufficient to fund our future business activities and requirements, including any potential portfolio purchases, we may need to raise additional funds through public or private equity or debt financing. We cannot provide assurance that we will be able to raise additional funds on favorable terms, if at all.

Prefunds

Under our contracts with the vast majority of our employer clients, we receive prefunds that have been and are expected to continue to be a significant source of cash flows from operating activities. Our client contracts do not contain restrictions on our use of client prefunds and, as a result, each prefund is reflected in cash and cash equivalents on our consolidated balance sheet with an equivalent customer obligation recorded as a liability as the prefund is received. Changes in these prefunds and the corresponding customer obligations are reflected in our cash flows from operating activities. The timing of when employer clients make their prefunds as well as the timing of when we make payments on behalf of employee participants can significantly affect our cash flows.

The operation of these prefunds for our employer clients throughout the year typically is as follows: at the beginning of a plan year, these employer clients provide us with prefunds for their FSA and HRA programs based on a percentage of projected spending by the employee participants for the plan year and other factors. In the case of our commuter program, at the beginning of each month we receive prefunds based on the employee participants’ monthly elections. These prefunds are typically replenished on a weekly basis by our FSA and HRA employer clients and on a monthly basis by our commuter employer clients, in each case, the replenishment occurs after we have advanced the funds necessary to process employee participants’ FSA and HRA claims as they are submitted to us and to pay vendors

relating to our commuter programs. As a result, our cash balances can vary significantly depending upon the timing of invoicing and the date payment is received from our employer clients for reimbursement of payments we have made on behalf of employee participants.

MUFG Union Bank, N.A. Revolving Credit Facility

In the second quarter of 2015, we entered into an Amended and Restated Credit Agreement, or Credit Agreement, with certain lenders, including MUFG Union Bank, N.A, as administrative agent. The Credit Agreement provides for a \$150.0 million revolving credit facility, an increase option permitting us to arrange with existing lenders and/or new lenders to provide up to an aggregate of \$100.0 million in additional commitments, and a \$15.0 million subfacility for the issuances of letters of credit. In addition, the credit facility provides for stock repurchases from employees of up to an aggregate of \$1.0 million in any fiscal year. The Credit Agreement extended the term of the credit facility to June 5, 2020 and reduced the margin added to the London Interbank Offered Rate, or LIBOR, to a range from 125 to 175 basis points.

Table of Contents

In the third quarter of 2016, the Company entered into a first amendment of the Credit Agreement increasing the credit limit of the revolving credit facility to \$250.0 million. This amendment did not change the subfacility limit, terms, or maturity date of the credit facility which remained at June 5, 2020.

In connection with this amendment, the Company incurred fees of approximately \$0.2 million, which are being amortized over the term of the amendment. The fees incurred are classified as a direct deduction from the long-term debt line item in the consolidated balance sheets. The interest rate applicable on the revolving credit facility as of September 30, 2016 is 1.77%. As of September 30, 2016, the Company had \$79.6 million outstanding under the credit facility.

Amounts borrowed, outstanding letters of credit and amounts available to borrow, were as follows (in thousands):

	December 31, 2015	September 30, 2016
Amounts borrowed	\$ 79,600	\$ 79,600
Outstanding letters of credit	2,700	2,700
Amounts available to borrow (1)	67,700	167,700

(1) Amounts available to borrow at December 31, 2015 excludes \$100 million increase option

As collateral for the revolving credit facility, we granted MUFG Union Bank, N.A. a security interest in substantially all of our assets. All of our material existing and future subsidiaries are required to guarantee our obligations under the revolving credit facility. Such guarantees by existing and future material subsidiaries are and will be secured by substantially all of the property of such material subsidiaries.

The revolving credit facility contains customary affirmative and negative covenants and also has financial covenants relating to a consolidated leverage ratio and an interest coverage ratio. We are obligated to pay customary commitment fees and letter of credit fees for a facility of this size and type. We are currently in compliance with all financial and non-financial covenants under the revolving credit facility.

The revolving credit facility contains customary events of default, including, among others, payment defaults, covenant defaults, inaccuracy of representations and warranties, cross-defaults to other material indebtedness, judgment defaults, a change of control and bankruptcy, and insolvency defaults. Under certain circumstances, a default interest rate will apply on all obligations during the existence of an event of default under the loan agreement at a per annum rate of interest equal to 2.00% above the applicable interest rate. Upon an event of default, the lenders may terminate the commitments, declare the outstanding obligations payable by us to be immediately due and payable, and exercise other rights and remedies provided for under the revolving credit facility.

Cash Flows

The following table presents information regarding our financial position including cash and cash equivalents:

	December 31, 2015	September 30, 2016
	(In thousands, unaudited)	
Cash and cash equivalents, end of period	\$500,918	\$ 666,634

The following table presents information regarding our cash position:

Edgar Filing: WAGEWORKS, INC. - Form 10-Q

Nine Months Ended
September 30,
2015 2016
(In thousands,
unaudited)

Net cash provided by operating activities	\$89,835	\$195,845
Net cash used in investing activities	(33,645)	(41,306)
Net cash provided by financing activities	8,501	11,177
Net increase in cash and cash equivalents	\$64,691	\$165,716

Table of Contents

Cash Flows from Operating Activities

Net cash provided by operating activities increased during the nine months ended September 30, 2016 as compared to the prior-year period by \$106.0 million. Cash provided by operating activities during the nine months ended September 30, 2016 resulted from our net income of \$14.5 million adjusted for the following non-cash items: \$6.2 million for depreciation, \$26.0 million for amortization and change in contingent consideration, and \$22.4 million for stock-based compensation expense. Cash provided by operating activities increased driven mainly by an increase in customer obligations primarily from funds received from the Federal agencies, COBRA and Commuter programs as a result of the transition of Ceridian's COBRA and direct bill portfolio to the Company, and the increase in maximum pre-tax monthly benefit as well as a larger commuter client base. Cash provided by operating activities was offset by an increase to accounts receivable due primarily to timing of collections as a result of increased sales volume and lower cash provided by accounts payable and accrued expenses due to timing of payment to transit agencies.

Cash Flows from Investing Activities

Net cash used in investing activities increased during the nine months ended September 30, 2016, as compared to the prior-year period, by \$7.7 million, due primarily to payments made for the acquisition of intangible assets for the transition of Ceridian's COBRA and direct bill portfolio to the Company. This increase was offset by a decrease in capital expenditures.

Cash Flows from Financing Activities

Net cash provided by financing activities increased during the nine months ended September 30, 2016, as compared to the prior-year period, by \$2.7 million, due primarily to an increase in proceeds from exercise of stock options, an increase in the tax benefit related to stock based compensation, and a decrease in payments related to contingent consideration, offset by payments made for share repurchase activities in 2016.

Contractual Obligations

The following table describes our contractual obligations as of September 30, 2016 (unaudited):

	Total	Less than 1 year	1-3 years	3-5 years	More than 5 years
Long-term debt obligations (1)	\$79,600	\$—	\$—	\$79,600	\$—
Interest on long-term debt obligations (2)	5,174	1,380	2,759	1,035	—
Operating lease obligations (3)	47,593	8,347	15,919	15,266	8,061
Total	\$132,367	\$9,727	\$18,678	\$95,901	\$8,061

(1) As of September 30, 2016, maximum borrowings under the revolving credit facility are \$250.0 million with a base rate determined in accordance with the credit agreement or, at our option, LIBOR plus a spread of 1.25% to 1.75% per annum, and a maturity date of June 5, 2020. At September 30, 2016, we had \$79.6 million of outstanding

principal which is recorded net of debt issuance costs on our consolidated balance sheets. The debt issuance costs are not included in the table above.

- (2) Estimated interest payments assume the interest rate applicable as of September 30, 2016 of 1.77% per annum on a \$79.6 million principal amount.
- (3) We lease facilities under non-cancelable operating leases expiring at various dates through 2023.

Off-Balance Sheet Arrangements

We have no off-balance sheet arrangements.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Table of Contents

There have been no material changes in our market risk during the nine months ended September 30, 2016. For additional information, see Part II, Item 7A., “Quantitative and Qualitative Disclosures About Market Risk”, of our Annual Report on Form 10-K for the year ended December 31, 2015.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

We maintain “disclosure controls and procedures,” as such term is defined in Rule 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, or the Exchange Act, that are designed to ensure that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission, or the SEC, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure. In designing and evaluating our disclosure controls and procedures, management recognizes that disclosure controls and procedures, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the disclosure controls and procedures are met.

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures pursuant to Rule 13a-15 under the Securities Exchange Act of 1934, as amended (Exchange Act), as of the end of the period covered by this Quarterly Report on Form 10-Q.

Based on this evaluation, our Chief Executive Officer and Chief Financial Officer concluded that, as of September 30, 2016, our disclosure controls and procedures are designed at a reasonable assurance level and are effective to provide reasonable assurance that information we are required to disclose in reports that we file or submit under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in the SEC’s rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosures.

Changes in Internal Control over Financial Reporting

There was no change in our internal control over financial reporting identified in connection with the evaluation required by Rule 13a-15(d) or the Exchange Act that occurred during the period covered by this Quarterly Report on Form 10-Q that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

From time-to-time, we may be subject to various legal proceedings and claims that arise in the normal course of our business activities. As of the date of this Quarterly Report on Form 10-Q, we are not a party to any litigation whereby the outcome of such litigation, if determined adversely to us, would individually or in the aggregate be reasonably expected to have a material adverse effect on our results of operations, prospects, cash flows, financial position, or brand.

Item 1A. Risk Factors

There have been no material changes in our risk factors disclosed in Part I, Item 1A, “Risk Factors”, of our Annual Report on Form 10-K for the year ended December 31, 2015.

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

Stock Repurchases

There were no repurchases of common stock by the Company during the three months ended September 30, 2016.

Item 6. Exhibits

Table of Contents

The exhibits listed in the accompanying Exhibit Index are filed or incorporated by reference as part of this Quarterly Report.

Table of Contents

SIGNATURES

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

WAGEWORKS, INC.

Date: November 9, 2016 By: /s/ COLM M CALLAN

Colm M Callan
Chief Financial Officer
(Principal Financial Officer)

/s/ COLM M CALLAN

Colm M Callan
Chief Financial Officer
(Principal Accounting Officer)

Table of Contents

Exhibit Index

Exhibit No.	Exhibit Description	Incorporated by Reference			
		Form No.	File No.	Exhibit Date	Filed Herewith
31.1	Certification of the Principal Executive Officer Pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002				X
31.2	Certification of the Principal Financial Officer Pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002				X
32.1(1)	Certification of the Principal Executive Officer and Principal Financial Officer Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002				X
10.10G	First Amendment to the Second Amendment to Credit Agreement, by and among Registrant, MUFG Union Bank, N.A. (formerly Union Bank, N.A.), MHM Resources, LLC and Benefit Concepts, Inc. of Rhode Island, dated August 1, 2016.				X
101.INS	XBRL Instance Document				
101.SCH	XBRL Taxonomy Schema Linkbase Document				
101.CAL	XBRL Taxonomy Calculation Linkbase Document				
101.DEF	XBRL Taxonomy Definition Linkbase Document				
101.LAB	XBRL Taxonomy Labels Linkbase Document				
101.PRE	XBRL Taxonomy Presentation Linkbase Document				

The certifications attached as Exhibit 32.1 that accompany this Quarterly Report on Form 10-Q are not deemed filed with the Securities and Exchange Commission and are not to be incorporated by reference into any filing of (1) WageWorks, Inc. under the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended, whether made before or after the date of this Form 10-Q, irrespective of any general incorporation language contained in such filing.