

PROS Holdings, Inc.  
Form 10-Q  
November 02, 2007

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington D.C. 20549

**FORM 10-Q**

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

**For the quarterly period ended September 30, 2007**

**OR**

**o** **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: 333-141884**

**PROS HOLDINGS, INC.**

(Exact name of registrant as specified in its charter)

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

**76-0168604**  
(I.R.S. Employer Identification No.)

**3100 Main Street, Suite 900, Houston, TX 77002**

**(713) 335-5151**

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(Address and telephone number of principal executive offices)

Indicate by check mark whether 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) had been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act). (Check one):

Large Accelerated Filer  Accelerated Filer  Non-Accelerated Filer

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

The number of shares outstanding of the Registrant's Common Stock, \$0.01 par value, was 25,999,913 as of November 2, 2007.

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**PROS HOLDINGS, INC.**

**Form 10-Q for the Quarter Ended September 30, 2007**

**TABLE OF CONTENTS**

**PART I. FINANCIAL INFORMATION**

**Item 1. Unaudited Financial Statement**

**Condensed Consolidated Balance Sheets as of September 30, 2007 and December 31, 2006**

**Condensed Consolidated Statements of Income for the three and nine months ended September 30, 2007 and 2006**

**Condensed Consolidated Statements of Cash Flows for the nine months ended September 30, 2007 and 2006**

**Notes to Condensed Consolidated Financial Statements**

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

**Item 3. Quantitative and Qualitative Disclosures About Market Risk**

**Item 4. Controls and Procedures**

**PART II. OTHER INFORMATION**

**Item 1. Legal Proceedings**

**Item 1A. Risk Factors**

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

**Item 3. Defaults Upon Senior Securities**

**Item 4. Submission of Matters to a Vote of Security Holders**

**Item 5. Other Information**

**Item 6. Exhibits**

**SIGNATURES**

**Cautionary Statement**

*Except for the historical financial information contained herein, the matters discussed in this report on Form 10-Q (as well as documents incorporated herein by reference) may be considered forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Such forward-looking statements include declarations regarding the intent, belief or current expectations of PROS Holdings, Inc. and its management and may be signified by the words expects, anticipates, target, project, goals, estimates, potential, predicts, may, might, could, intends, believes or similar language. You are cautioned that any such forward-looking statements are not guarantees of future performance and involve a number of risks and uncertainties. Actual results could differ materially from those indicated by such forward-looking statements. Factors that could cause or contribute to such differences include those discussed under Risk Factors and elsewhere in this report. PROS Holdings, Inc. disclaims any intention or obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.*



**PART I. FINANCIAL INFORMATION****Item 1. Condensed Unaudited Consolidated Financial Statements****PROS Holdings, Inc.****Condensed Consolidated Balance Sheets****(unaudited)**

|   | September 30,<br>2007 | December 31,<br>2006 |
|---|-----------------------|----------------------|
| <b>Assets</b>   |                       |                      |
| Current assets:   |                       |                      |
| Cash and cash equivalents   | \$ 40,011,604         | \$ 42,540,180        |
| Accounts and unbilled receivables, net of allowance of \$1,220,000 and \$1,190,000 respectively   | 14,921,151            | 13,788,989           |
| Prepaid expenses and other current assets   | 3,850,691             | 2,199,997            |
| <b>Total current assets</b>   | <b>58,783,446</b>     | <b>58,529,166</b>    |
| Property and equipment, net   | 3,141,828             | 2,372,872            |
| Other assets  | 2,492,477             | 2,144,371            |
| <b>Total assets</b>   | <b>\$ 64,417,751</b>  | <b>\$ 63,046,409</b> |
| <b>Liabilities and stockholders equity</b>  |                       |                      |
| Current liabilities:  |                       |                      |
| Accounts payable  | \$ 1,446,615          | \$ 584,372           |
| Accrued liabilities   | 3,390,989             | 3,965,817            |
| Accrued contract labor  | 1,017,745             | 1,405,287            |
| Accrued payroll   | 2,589,062             | 2,918,979            |
| Deferred revenue  | 22,190,764            | 22,079,937           |
| <b>Total current liabilities</b>  | <b>30,635,175</b>     | <b>30,954,392</b>    |
| Long-term deferred revenue  | 5,264,086             | 4,131,757            |
| Commitments and contingencies   |                       |                      |
| Redeemable preferred stock, \$0.001 par value, 3,921,312 shares authorized, 0 and 2,627,282 shares outstanding, respectively                            |                       | 17,283,168           |
| Stockholders equity:  |                       |                      |
| Common stock, 75,000,000 and 28,000,000 shares authorized, 29,646,224 and 23,580,729 issued, 25,799,184 and 19,733,689 shares outstanding, respectively | 29,646                | 23,581               |
| Additional paid-in capital  | 51,418,790            | 7,812,536            |
| Common stock warrants   | 226,000               | 226,000              |
| Treasury stock, 3,847,040 common shares at cost   | (8,937,500)           | (8,937,500)          |

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|  |               |               |
|--|---------------|---------------|
| Retained (deficit) earnings                | (14,218,446)  | 11,552,475    |
| Total stockholders' equity                 | 28,518,490    | 10,677,092    |
| Total liabilities and stockholders' equity | \$ 64,417,751 | \$ 63,046,409 |

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

## PROS Holdings, Inc.

## Condensed Consolidated Statements of Income

(unaudited)

|   | Three Months Ended September 30, |              | Nine Months Ended September 30, |               |
|---|----------------------------------|--------------|---------------------------------|---------------|
|   | 2007                             | 2006         | 2007                            | 2006          |
| <b>Revenue:</b>   |                                  |              |                                 |               |
| License and implementation                                  | \$ 11,661,407                    | \$ 8,275,078 | \$ 30,577,733                   | \$ 20,639,078 |
| Maintenance and support                                     | 4,768,382                        | 4,190,343    | 13,718,877                      | 12,178,920    |
| Total revenue   | 16,429,789                       | 12,465,421   | 44,296,610                      | 32,817,998    |
| <b>Cost of Revenue:</b>                                     |                                  |              |                                 |               |
| License and implementation                                  | 3,275,936                        | 3,281,543    | 9,682,794                       | 8,548,802     |
| Maintenance and support                                     | 1,365,449                        | 893,884      | 3,459,189                       | 2,712,512     |
| Total cost of revenue                                       | 4,641,385                        | 4,175,427    | 13,141,983                      | 11,261,314    |
| Gross profit  | 11,788,404                       | 8,289,994    | 31,154,627                      | 21,556,684    |
| <b>Operating expenses:</b>                                  |                                  |              |                                 |               |
| Selling, general and administrative                         | 4,605,161                        | 3,477,010    | 11,530,223                      | 10,046,647    |
| Research and development                                    | 4,329,289                        | 2,670,879    | 12,394,270                      | 7,075,432     |
| Income from operations                                      | 2,853,954                        | 2,142,105    | 7,230,134                       | 4,434,605     |
| Other income (expense):                                     |                                  |              |                                 |               |
| Interest income   | 505,650                          | 497,900      | 1,100,514                       | 1,405,135     |
| Interest and deferred finance costs                         | (410,905)                        |              | (868,982)                       |               |
| Income before income tax provision (benefit)                | 2,948,699                        | 2,640,005    | 7,461,666                       | 5,839,740     |
| Income tax provision (benefit)                              | (552,350)                        | 520,321      | 398,074                         | 1,150,960     |
| Net income  | 3,501,049                        | 2,119,684    | 7,063,592                       | 4,688,780     |
| Accretion of preferred stock                                |                                  | (109,361)    | (81,915)                        | (371,861)     |
| Net earnings attributable to common stockholders            | \$ 3,501,049                     | \$ 2,010,323 | \$ 6,981,677                    | \$ 4,316,919  |
| Net earnings attributable to common stockholders per share: |                                  |              |                                 |               |
| Basic   | \$ 0.14                          | \$ 0.10      | \$ 0.32                         | \$ 0.22       |
| Diluted   | \$ 0.13                          | \$ 0.10      | \$ 0.31                         | \$ 0.21       |
| Weighted average number of shares:                          |                                  |              |                                 |               |
| Basic   | 25,681,570                       | 19,673,981   | 22,038,459                      | 19,622,655    |
| Diluted   | 26,247,871                       | 20,990,329   | 22,509,178                      | 20,756,902    |

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



## PROS Holdings, Inc.

## Condensed Consolidated Statements of Cash Flows

(unaudited)

|   | Nine Months Ended September 30, |               |
|---|---------------------------------|---------------|
|   | 2007                            | 2006          |
| <b>Operating activities:</b>  |                                 |               |
| Net income  | \$ 7,063,592                    | \$ 4,688,780  |
| Adjustments to reconcile net income to net cash provided by operating activities: |                                 |               |
| Depreciation and amortization   | 886,956                         | 994,627       |
| Noncash stock based compensation  | 931,744                         |               |
| Deferred income taxes   | (1,183,405)                     |               |
| Deferred financing costs  | 417,810                         |               |
| Changes in operating assets and liabilities:                                      |                                 |               |
| Accounts receivable and unbilled receivables, net                                 | (1,132,162)                     | (4,576,756)   |
| Prepaid expenses and other  | (815,395)                       | (1,274,750)   |
| Accounts payable, accrued liabilities, accrued contract labor and accrued payroll | (654,363)                       | (494,611)     |
| Deferred revenue  | 1,243,156                       | 7,092,776     |
| Net cash provided by operating activities   | 6,757,933                       | 6,430,066     |
| <b>Investing activities:</b>  |                                 |               |
| Purchases of property and equipment   | (1,655,912)                     | (748,644)     |
| Net cash used in investing activities   | (1,655,912)                     | (748,644)     |
| <b>Financing activities:</b>  |                                 |               |
| Proceeds from long-term debt  | 20,000,000                      |               |
| Proceeds from initial public offering, net of underwriters costs                  | 52,364,813                      |               |
| Payment on long-term debt   | (20,000,000)                    |               |
| Dividend on common stock  | (41,328,294)                    |               |
| Redemption of redeemable preferred stock  | (17,365,083)                    | (8,445,471)   |
| Exercise of stock options   | 684,705                         | 60,528        |
| Offering costs  | (1,568,928)                     |               |
| Deferred financing costs  | (417,810)                       |               |
| Net cash used in financing activities   | (7,630,597)                     | (8,384,943)   |
| Net decrease in cash and cash equivalents   | (2,528,576)                     | (2,703,521)   |
| <b>Cash and cash equivalents:</b>   |                                 |               |
| Beginning of period   | 42,540,180                      | 38,489,803    |
| End of period   | \$ 40,011,604                   | \$ 35,786,282 |

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



**PROS Holdings, Inc.**

**Notes to Condensed Consolidated Financial Statements**

**(unaudited)**

**1. Summary of Business and Basis of Presentation**

**Nature of operations**

PROS Holdings, Inc., ( our or the Company ) is a provider of pricing and revenue optimization software products, a category of enterprise applications designed to allow companies to improve financial performance by enabling better pricing. Customers use the Company s software products to gain insight into their pricing strategies, identify detrimental pricing activities, optimize their pricing decision-making and improve their business processes and financial performance. The Company s software products incorporate advanced pricing science, which includes operations research, forecasting and statistics. These innovative science-based software products analyze, execute and optimize pricing strategies using data from traditional enterprise applications, often augmenting it with real-time and historical data. The Company also provides a range of services that include analyzing a company s current pricing processes and implementing the Company s software products to improve pricing performance. The Company provides its software products to enterprises across a range of industries, including manufacturing, distribution, services, hotel and cruise, and airline.

The condensed consolidated financial statements included in this quarterly report on Form 10-Q have been prepared by the Company without audit, pursuant to the rules and regulations of the Securities and Exchange Commission (the SEC ). Certain information and footnote disclosures normally included in consolidated financial statements prepared in accordance with U.S. generally accepted accounting principles ( GAAP ) have been condensed or omitted pursuant to such rules and regulations. However, the Company believes that the disclosures contained in this quarterly report on Form 10-Q comply with the requirements of Section 13(a) of the Securities Exchange Act of 1934, as amended, for a quarterly report on Form 10-Q and are adequate to make the information presented not misleading. The condensed consolidated financial statements included herein reflect all adjustments (consisting of normal recurring adjustments) which are, in the opinion of management, necessary for a fair statement of the financial position, results of operations and cash flows for the interim periods presented. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto contained in the Company s prospectus dated June 27, 2007. The year end condensed consolidated balance sheet data was derived from audited financial statements, but does not include all disclosures required by GAAP. The results of operations for the three and nine months ended September 30, 2007 is not necessarily indicative of the results to be anticipated for the entire year ending December 31, 2007 or thereafter.

**Initial public offering**

In July 2007, the Company completed its initial public offering of common stock (the IPO ) in which the Company sold and issued 5,118,750 shares of common stock and selling stockholders sold an additional 1,706,250 shares of common stock. The Company s Certificate of Incorporation, as restated on June 22, 2007, authorizes the issuance of 75,000,000 shares of common stock and 5,000,000 shares of preferred stock, each with \$0.001 par value per share.

As a result of the IPO, the Company raised a total of \$56,306,250 in gross proceeds, and \$52,364,813 in net proceeds after deducting underwriting discounts and commissions of \$3,941,437. In addition, the Company incurred \$1,793,247 of offering costs associated with the IPO that were recorded to additional paid-in capital and netted against the IPO proceeds. The Company did not receive any proceeds from the sale of shares in the IPO



by the selling stockholders. In addition, the underwriters of its initial public offering have exercised in full their over-allotment option to purchase an additional 1,023,750 shares of common stock from selling stockholders at the initial public offering price of \$11.00 per share. The over-allotment option was granted to the underwriters by the selling stockholders and PROS did not issue any new shares of common stock or receive any proceeds from the sale of these shares.

## Income Taxes

In June 2006, the FASB issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109*, or FIN 48. FIN 48 clarifies the accounting for uncertainties in income taxes recognized in an enterprise's financial statements. FIN 48 requires the Company to determine whether it is more likely than not that a tax position will be sustained upon examination by the appropriate taxing authority. If a tax position meets the more likely than not recognition criteria, FIN 48 requires the tax position be measured at the largest amount of benefit greater than 50% likely of being realized upon ultimate settlement. We adopted the provisions of FIN 48 on January 1, 2007. As a result of the adoption of FIN 48, we did not incur a tax liability. Any interest and penalties accrued related to uncertain tax positions will be recognized in income tax provision.

Included in our tax expense for the third quarter of 2007 is a benefit of \$1.1 million due to the reversal of a valuation allowance previously recorded against our deferred tax assets. The reversal is the result of our conclusion that it is more likely than not that the associated deferred tax assets will be realized. Without this reversal our effective tax rate would have been 20%. Our effective tax rate historically has been lower than the statutory rate of 34% largely due to the application of general business tax credits, and we expect to continue to benefit from these credits for the foreseeable future.

## Recent accounting pronouncements

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*, which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS No. 157 does not require any new fair value measurements, but provides guidance on how to measure fair value by providing a fair value hierarchy used to classify the source of the information. SFAS No. 157 is effective for the Company's fiscal year beginning January 1, 2008. The Company is currently evaluating the impact of adopting SFAS No. 157.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115*. This pronouncement permits entities to use the fair value method to measure certain financial assets and liabilities by electing an irrevocable option to use the fair value method at specified election dates. After election of the option, subsequent changes in fair value would result in the recognition of unrealized gains or losses as period costs during the period the change occurred. SFAS No. 159 becomes effective as of the beginning of the first fiscal year that begins after November 15, 2007, with early adoption permitted. However, entities may not retroactively apply the provisions of SFAS No. 159 to fiscal years preceding the date of adoption. The Company is currently evaluating the effect that SFAS No. 159 may have on its financial position, results of operations and cash flows.

## 2. Earnings per share

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

|  | Three months ended September 30, |              | Nine months ended September 30, |              |
|--|----------------------------------|--------------|---------------------------------|--------------|
|  | 2007                             | 2006         | 2007                            | 2006         |
| <b>Numerator:</b>  |                                  |              |                                 |              |
| Net earnings attributable to common stockholders (basic) | \$ 3,501,049                     | \$ 2,010,323 | \$ 6,981,677                    | \$ 4,316,919 |
| <b>Denominator:</b>                                      |                                  |              |                                 |              |
| Weighted average shares (basic)                          | 25,681,570                       | 19,673,981   | 22,038,459                      | 19,622,655   |
| Dilutive effect of stock options and warrants            | 566,301                          | 1,316,348    | 470,719                         | 1,134,246    |
| Weighted average shares (diluted)                        | 26,247,871                       | 20,990,329   | 22,509,178                      | 20,756,901   |
| Basic earnings per share                                 | \$ 0.14                          | \$ 0.10      | \$ 0.32                         | \$ 0.22      |
| Diluted earnings per share                               | \$ 0.13                          | \$ 0.10      | \$ 0.31                         | \$ 0.21      |

## 3. Stockholders equity

### Stock options

The Company maintains incentive stock option plans to provide long-term incentives to its key employees, officers, directors and consultants under which 2,220,560 shares of common stock were reserved for issuance. As of September 30, 2007, 492,500 shares remained available for grant. Options generally have a ten-year term and vest over three or four years. At September 30, 2007, there was an estimated \$6.1 million of total unrecognized compensation cost related to share-based compensation arrangements for options granted in 2007.

The following is a summary of the Company's option activity for the nine month period ended September 30, 2007:

|                                 | Number of shares under option | Weighted average exercise price | Aggregate intrinsic value |
|---------------------------------|-------------------------------|---------------------------------|---------------------------|
| Outstanding, December 31, 2006  | 1,449,105                     | \$ 0.94                         |                           |
| Granted                         | 1,382,500                     | 6.82                            |                           |
| Forfeited                       | (176,800)                     | 2.29                            |                           |
| Exercised                       | (946,745)                     | 0.72                            |                           |
| Outstanding, September 30, 2007 | 1,708,060                     | 5.68                            | \$ 10,914,503             |
| Exercisable September 30, 2007  | 148,270                       | \$ 3.24                         | \$ 1,309,224              |

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The following table summarizes information about stock options outstanding at September 30, 2007:

| Range of exercise prices | Options outstanding                           |  |                                       | Options exercisable                           |  |       |
|--------------------------|---|--|---------------------------------------|---|--|-------|
|                          | Outstanding<br>as of<br>September 30,<br>2007 | Weighted<br>average<br>remaining<br>contractual<br>life (in years) | Weighted<br>average<br>exercise price | Exercisable<br>as of<br>September 30,<br>2007 | Weighted<br>average<br>exercise<br>price |       |
| \$ 0.00-\$0.25           | 52,750  | 6.7  | \$ 0.25                               | 8,750   | \$                                       | 0.25  |
| \$ 0.26-\$1.00           | 212,760                                       | 8.0  | \$ 0.58                               | 36,960  | \$                                       | 0.64  |
| \$ 1.01-\$3.00           | 65,050  | 2.7  | \$ 2.56                               | 65,050  | \$                                       | 2.56  |
| \$ 3.01-\$6.00           | 1,150,000                                     | 9.5  | \$ 6.00                               | 25,000  | \$                                       | 6.00  |
| \$ 6.01-\$11.00          | 227,500                                       | 9.7  | \$ 11.00                              | 12,510  | \$                                       | 11.00 |
|                          | 1,708,060                                     | 9.0  | \$ 5.68                               | 148,270                                       | \$                                       | 3.24  |

#### 4. Credit Facility

On March 23, 2007, the Company entered into a \$28.0 million credit facility with a commercial bank, consisting of a \$20.0 million term loan and a \$8.0 million line of credit. Interest was payable at a Eurodollar rate plus 2.75% or a base rate plus 1.5%, at the Company's option (8.09% at June 30, 2007). The term loan required repayment of principal of \$50,000 plus interest every three months for five years, with all unpaid principal due on March 23, 2012. On July 3, 2007, the Company used \$20,066,000 of proceeds from its IPO to retire the remaining \$19,950,000 principle balance of the credit facility and related accrued interest totaling \$116,000. In connection with the payoff and termination of the credit facility on July 3, 2007, financing fees in the amount of \$397,000, which were included in other assets in the Company's condensed consolidated balance sheet were expensed in the third quarter of 2007.

## Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

*The terms we, us and our refer to PROS Holdings, Inc. and all of its subsidiaries that are consolidated in conformity with United States generally accepted accounting principles.*

### Cautionary Statement

The following discussion should be read along with the unaudited condensed consolidated financial statements and notes included in Item 1 of this Quarterly Report on Form 10-Q, as well as the audited consolidated financial statements and notes and Management's Discussion and Analysis of Financial Condition and Results of Operations for the year ended December 31, 2006 set forth in our prospectus effective on June 27, 2007 and filed with the Securities and Exchange Commission (SEC). This Management's Discussion and Analysis of Financial Condition and Results of Operations contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These forward-looking statements regarding future events and our future results are based on current expectations, estimates, forecasts and projections, and the beliefs and assumptions of our management including, without limitation, our expectations regarding the following: the sales of our software products and services; the impact of our revenue recognition; our belief that our current assets, including cash, cash equivalents and investments, and expected cash flows from operating activities, will be sufficient to fund our operations; our anticipated additions to property, plant and equipment; our belief that our facilities are suitable and adequate to meet our current operating needs; our belief that that we do not have any material exposure to changes in the fair value of our investment portfolio as a result of changes in interest rates. Words such as we expect, anticipate, target, project, believe, goals, estimate, potential, predict, may, might, could, intend, variations of these similar expressions are intended to identify these forward-looking statements. Readers are cautioned that these forward-looking statements are predictions and are subject to risks, uncertainties, and assumptions that are difficult to predict. Therefore, actual results may differ materially and adversely from those expressed in any forward-looking statements.

Among the important factors that could cause actual results to differ materially from those indicated by our forward-looking statements are those discussed in Part II, Item 1A Risk Factors of this Quarterly Report on Form 10-Q and elsewhere in this report. We undertake no obligation to revise or update publicly any forward-looking statement for any reason. Readers should carefully review the risk factors described in this Quarterly Report on Form 10-Q, as well as the documents filed by us with the SEC, specifically our prospectus effective June 27, 2007 and filed with the SEC on June 28, 2007, as they may be amended from time to time.

### Overview

We are a leading provider of pricing and revenue optimization software, an emerging category of enterprise applications designed to allow companies to improve financial performance by enabling better pricing. By using our software products, customers gain insight into their pricing strategies, identify detrimental pricing practices, optimize their pricing decision-making and improve their business processes and financial performance. Our software products incorporate advanced pricing science, which includes operations research, forecasting and statistics. Our innovative science-based software products analyze, execute and optimize pricing strategies using data from traditional enterprise applications, often augmenting it with real-time and historical data. We also provide a range of services that include analyzing a company's current pricing processes and implementing our software products to improve pricing performance. We provide our software products to enterprises across a range of industries, including manufacturing, distribution, services, hotel and cruise, and airline. We were incorporated in Texas in 1985, reincorporated as a Delaware corporation in 1998 and reorganized as a Delaware holding company in 2002. Our headquarters are located in Houston, Texas.



## **Revenue**

We derive our revenue from license fees, implementation services and maintenance and support services. Our arrangements with customers typically include: (a) license fees paid for the use of our products either in perpetuity or over a specified term and implementation fees for configuration, implementation and training services and (b) maintenance and support fees related to technical support and software updates. We consider our implementation services essential to the usability of our licensed software products, and therefore we recognize revenue from perpetual software license and implementation services together as the services are performed. For certain of our arrangements, we engage an independent contractor to assist in the implementation. We recognize revenue from these engagements net of the fees owed to the independent contractor.

*License and implementation revenue.* We derive the substantial majority of our license and implementation revenue from the sale of perpetual licenses for our software products and related implementation services. Revenue from our perpetual licenses and implementation services are generally recognized as implementation services are performed on a percentage-of-completion basis.

We also recognize revenue from the sale of a limited number of fixed-term licenses, which have terms ranging from three months to five years, and related implementation services. During the three months and nine months ended September 30, 2007, license and implementation revenue from fixed-term licenses represented approximately 5% of our total revenue for both periods. Revenue from fixed-term licenses, which includes maintenance and support during the license period, are recognized ratably over the license term.

*Maintenance and support revenue.* We generate maintenance and support revenue from the sale of maintenance and support services for our software products. Our maintenance and support arrangements are sold with terms generally ranging from one to two years. Maintenance and support fees are invoiced to our customers either monthly, quarterly or on an annual basis. Maintenance and support revenue includes post-contract customer support and the right to unspecified software updates and enhancements on a when and if available basis. Renewal of maintenance and support agreements by customers are in mid 90% range.

## **Cost of revenue**

*Cost of license and implementation revenue.* Cost of license and implementation revenue includes those costs related to the implementation of our solutions. Cost of license and implementation revenue consists of (a) compensation and benefits related to personnel providing professional services, (b) billable and non-billable travel, lodging and other out-of-pocket expenses and (c) facilities and other overhead costs. As a percentage of related revenue, cost of license and implementation revenue is higher than cost of maintenance and support revenue.

*Cost of maintenance and support revenue.* Cost of maintenance and support revenue includes those costs related to post-contract support on our deployed solutions. Cost of maintenance and support revenue consists of (a) compensation and benefits related to personnel providing customer support and (b) facilities and other overhead costs.

### ***Operating expenses***

***Selling, general and administrative.*** Selling, general and administrative expenses consist of (a) compensation and benefits related to selling, general and administrative activities; (b) travel, lodging and other out-of-pocket expenses; (c) marketing programs such as our conferences and participating in industry trade shows; (d) accounting, legal and other professional fees and (e) facilities and other related overhead. We expect absolute dollar increases in selling, general and administrative expenses as we incur additional expenses related to being a publicly-traded company, increase our general marketing activities, increase the number of our sales and marketing professionals and invest in infrastructure to support continued growth.

***Research and development*** Research and development expenses consist of (a) compensation and benefits of software developers, scientists and product managers working on the development of our new products, enhancements of existing products, scientific research, quality assurance and testing and (b) facilities and other related overhead. We expense all of our research and development costs as incurred, and we expect to continue to do so in the foreseeable future. We expect research and development expenses to increase in absolute dollars for the foreseeable future as we continue to invest in the development of our software products.

### ***Income taxes***

Our effective tax rates for the three months and nine months ended September 30, 2007 were (19%) and 5%, respectively. Included in our tax expense for the third quarter of 2007 is a benefit of \$1.1 million due to the reversal of a valuation allowance previously recorded against our deferred tax assets. The reversal is the result of our conclusion during the quarter that it is more likely than not that the associated deferred tax assets will be realized. Without this reversal our effective tax rate would have been 20%. Our effective tax rate historically has been lower than the statutory rate of 34% largely due to the application of general business tax credits, and we expect to continue to benefit from these credits for the foreseeable future.

If our taxable income continues to increase, future general business tax credits may not be available at levels that will allow us to maintain effective tax rates at current levels. As such, increases in our taxable income may be partially offset by increases in our effective tax rate.

### ***Deferred revenue and unbilled receivables***

For our license fees and implementation services, we invoice and are paid based upon negotiated milestones in each customer arrangement with an initial payment due upon execution and remaining payments due throughout the implementation period. We record as deferred revenue any invoices that have been issued before implementation services have been performed and before the corresponding license and implementation revenue is recognized. We record as unbilled receivables any recognized license and implementation revenue in excess of the amount invoiced to the customer. We generally invoice for our maintenance and support services on a monthly, quarterly or annual basis through the maintenance and support period. Deferred revenue does not reflect the total contract value of our customer arrangements at any point in time because we only record deferred revenue as amounts are invoiced ahead of the performance of implementation services. As a result, there is little correlation between the timing of our revenue recognition, the timing of our invoicing and the amount of deferred revenue.

### ***Application of critical accounting policies and use of estimates***

We prepare our condensed consolidated financial statements in accordance with accounting principles generally accepted in the United States of America, or GAAP. We made estimates and assumptions in the preparation of our condensed consolidated financial statements, and our estimates and assumptions may affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the condensed consolidated financial statements, and the reported amounts of revenue and expenses during the reporting periods. Actual results could differ from those estimates. The complexity and judgment of our estimation process and issues related to the assumptions, risks and uncertainties inherent in the application of the percentage-of-completion method of accounting affect the amounts of revenue, expenses, unbilled receivables and deferred revenue. Estimates are also

used for, but not limited to, receivables, allowance for doubtful accounts, useful lives of assets, depreciation, income taxes and deferred tax asset valuation, valuation of stock options and accrued liabilities. Numerous internal and external factors can affect estimates. Our management has reviewed these critical accounting policies, our use of estimates and the related disclosures with our audit committee.

Our accounting policies are more fully described in Note 1 to the Condensed Consolidated Financial Statements. We believe that the following discussion addresses our most critical accounting estimates, which are those that are most important to the portrayal of our financial condition and results of operations and require management's most difficult, subjective and complex judgments.

**Revenue recognition**

*License and implementation.* We consider our implementation services essential to our licensed software products, and therefore, we recognize revenue from perpetual software licenses and implementation services together as the services are performed. We do so using the percentage-of-completion method in accordance with the provisions contained within SOP 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*. The percentage-of-completion is measured as the total number of man-days expended on an implementation of our software products during a reporting period as a percentage of the total man-days estimated to be necessary to complete the implementation. The period over which we recognize license and implementation revenue depends on the number of licensed software products and the scope and complexity of the implementation requirements. Our revenue recognition period for an arrangement generally ranges from six months to several years.

*Maintenance and support.* Maintenance and support revenue includes post-contract customer support and the right to unspecified software updates and enhancements on a when and if available basis. Once an implementation is completed, maintenance and support revenue is recognized ratably over the term of the maintenance and support arrangement.

**Allowance for doubtful accounts**

In addition to our initial credit evaluations at the inception of arrangements, we regularly assess our ability to collect outstanding customer invoices. To do so, we must make estimates of the collectibility of accounts receivable. We provide an allowance for doubtful accounts when we determine that the collection of an outstanding customer receivable is not probable. We also analyze accounts receivable and historical bad debt experience, customer creditworthiness, changes in our customer payment history and industry concentration on an aggregate basis when evaluating the adequacy of the allowance for doubtful accounts. If any of these factors change, our estimates may also change, which could affect the level of our future provision for doubtful accounts.

**Results of Operations**

**Revenue:**

| (Dollars in thousands)     | Three Months Ended September 30, |                                  |           |                                  |             |            |
|----------------------------|----------------------------------|----------------------------------|-----------|----------------------------------|-------------|------------|
|                            | 2007                             |                                  | 2006      |                                  | Variance    |            |
|                            | Amount                           | As a percentage of total revenue | Amount    | As a percentage of total revenue | Variance \$ | Variance % |
| License and implementation | \$ 11,661                        | 71%                              | \$ 8,275  | 66%                              | \$ 3,386    | 41%        |
| Maintenance and support    | 4,769                            | 29%                              | 4,190     | 34%                              | 579         | 14%        |
| Total                      | \$ 16,430                        | 100%                             | \$ 12,465 | 100%                             | \$ 3,965    | 32%        |

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*License and implementation.* License and implementation revenue increased \$3.4 million from \$8.3 million for the three months ended September 30, 2006 to \$11.7 million for the three months ended September 30, 2007, representing a 41% increase. As we began implementation of software products, we began recognizing the related revenue. For the three months ended September 30, 2007, license and implementation revenue from industries other than the airline industry made up 69% of total license and implementation revenue as compared to 66% during the same period in 2006.

*Maintenance and support.* Maintenance and support revenue increased \$579,000 from \$4.2 million for the three months ended September 30, 2006 to \$4.8 million in the three months ended September 30, 2007, representing a 14% increase. The increase was a result of our completion of implementations of our software products after September 30, 2006 following which we were able to begin recognizing maintenance and support revenue related to those implementations. For the three months ended September 30, 2007 we had \$17,000 of maintenance revenue that was not renewed.

Within total revenue, airline revenue outside of the United States for the three months ended September 30, 2007 represented 95% of total airline revenue as compared to 92% during the same period in 2006.

| (Dollars in thousands)     | 2007      |                                  | Nine Months Ended September 30, 2006 |                                  | Variance \$ | Variance % |
|----------------------------|-----------|----------------------------------|--------------------------------------|----------------------------------|-------------|------------|
|                            | Amount    | As a percentage of total revenue | Amount                               | As a percentage of total revenue |             |            |
| License and implementation | \$ 30,578 | 69%                              | \$ 20,639                            | 63%                              | \$ 9,939    | 48%        |
| Maintenance and support    | 13,719    | 31%                              | 12,179                               | 37%                              | 1,540       | 13%        |
| Total                      | \$ 44,297 | 100%                             | \$ 32,818                            | 100%                             | \$ 11,479   | 35%        |

*License and implementation.* License and implementation revenue increased \$9.9 million from \$20.6 million for the nine months ended September 30, 2006 to \$30.6 million for the nine months ended September 30, 2007, representing a 48% increase. As we began implementation of software products, we began recognizing the related revenue. For the nine months ended September 30, 2007, license and implementation revenue from industries other than the airline industry made up 66% of total license and implementation revenue as compared to 64% during the same period in 2006.

*Maintenance and support.* Maintenance and support revenue increased \$1.5 million from \$12.2 million for the nine months ended September 30, 2006 to \$13.7 million for the nine months ended September 30, 2007, representing a 13% increase. The increase was a result of our completion of implementations of our software products after September 30, 2006 following which we were able to begin recognizing maintenance and support revenue related to those implementations. For the nine months ended September 30, 2007 we had \$178,000 of maintenance revenue that was not renewed.

Within total revenue, airline revenue outside of the United States for the nine months ended September 30, 2007 represented 95% of total airline revenue as compared to 93% during the same period in 2006.

*Cost of revenue and gross profit:*

| (Dollars in thousands)                     | Three Months Ended September 30,   |     |          |                                    |             |            |
|--|------------------------------------|-----|----------|------------------------------------|-------------|------------|
|  | 2007                               |     |          | 2006                               |             |            |
| Amount                                     | As a percentage of related revenue |     | Amount   | As a percentage of related revenue | Variance \$ | Variance % |
| Cost of license and implementation revenue | \$ 3,276                           | 28% | \$ 3,281 | 40%                                | \$ (5)      | 0%         |
| Cost of maintenance and support revenue    | 1,365                              | 29% | 894      | 21%                                | 471         | 53%        |
| Total cost of revenue                      | \$ 4,641                           | 28% | \$ 4,175 | 33%                                | \$ 466      | 11%        |
| Gross profit                               | \$ 11,788                          | 72% | \$ 8,290 | 67%                                | \$ 3,498    | 42%        |

*Cost of license and implementation revenue.* Cost of license and implementation revenue remained relatively unchanged for the three months ended September 30, 2006 and the three months ended September 30, 2007. License and implementation gross margin increased from 60% to 72% in the three months ended September 30, 2007 due to improvements in our implementation processes and the standardization of our software products. License and implementation cost may vary from period to period depending on factors, including the amount of implementation services required to deploy our products.

*Cost of maintenance and support revenue.* Cost of maintenance and support revenue increased \$471,000 from \$894,000 in the three months ended September 30, 2006 to \$1.4 million for the three months ended September 30, 2007, representing a 53% increase. The increase in cost of maintenance and support revenue is attributable to an increase in average support personnel in third quarter 2007. Maintenance and support gross margin decreased from 79% to 71% for the three months ended September 30, 2007 related to an overall increase in resources dedicated to maintenance and support projects and support personnel in 2007 to provide increased levels of support to our current and future installed customer base.

*Gross profit.* Gross profit increased \$3.5 million from \$8.3 million for the three months ended September 30, 2006 to \$11.8 million for the three months ended September 30, 2007, representing a 42% increase. The increase in our overall gross margin was attributable to the improvement in our license and implementation gross margins. License and implementation gross margin may vary from period to period depending on factors, including the amount of implementation services required to deploy our products related to the total contracted price.

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| (Dollars in thousands)                     | Nine Months Ended September 30,    |        |                                    |     |             |            |
|--|------------------------------------|--------|------------------------------------|-----|-------------|------------|
|  | 2007                               |        | 2006                               |     | Variance \$ | Variance % |
| Amount                                     | As a percentage of related revenue | Amount | As a percentage of related revenue |     |             |            |
| Cost of license and implementation revenue | \$ 9,683                           | 32%    | \$ 8,548                           | 41% | \$ 1,135    | 13%        |
| Cost of maintenance and support revenue    | 3,459                              | 25%    | 2,713                              | 22% | 746         | 27%        |
| Total cost of revenue                      | \$ 13,142                          | 30%    | \$ 11,261                          | 34% | \$ 1,881    | 17%        |
| Gross profit                               | \$ 31,155                          | 70%    | \$ 21,557                          | 66% | \$ 9,598    | 45%        |

*Cost of license and implementation revenue.* Cost of license and implementation revenue increased \$1.1 million from \$8.6 million for the nine months ended September 30, 2006 to \$9.7 million for the nine months ended September 30, 2007 representing a 13% increase. The increase in cost of license and implementation revenue is attributable to a \$641,000 increase in personnel costs, a \$594,000 increase in travel expenses and a \$158,000 increase in stock-based compensation expense from options issued in 2007 offset by decreases in other expenses. The increase in personnel and travel expenses related to an increase in the number and size of our in-progress implementations. License and implementation gross margin increased from 59% to 68% in the nine months ended September 30, 2007 due to improvements in our implementation processes and the standardization of our software products. License and implementation cost may vary from period to period depending on factors, including the amount of implementation services required to deploy our products.

*Cost of maintenance and support revenue.* Cost of maintenance and support revenue increased \$746,000 from \$2.7 million for the nine months ended September 30, 2006 to \$3.5 million for the nine months ended September 30, 2007, representing a 27% increase. The increase in cost of maintenance and support revenue is primarily attributable to an increase in average support personnel in 2007. Maintenance and support gross margins decreased from 78% to 75% for the nine months ended September 30, 2007 related to an overall increase in resources dedicated to maintenance and support projects and support personnel headcount in 2007 to provide increased levels of support to our current and future installed customer base.

*Gross profit.* Gross profit increased \$9.6 million from \$21.6 million for the nine months ended September 30, 2006 to \$31.2 million for the nine months ended September 30, 2007, representing a 45% increase. The increase in our gross margins were attributable to the improvement in our license and implementation gross margins. License and implementation gross margins may vary from period to period depending on factors, including the amount of implementation services required to deploy our products relative to the total contracted price.

| (Dollars in thousands)              | Three Months Ended September 30,   |        |                                    |     |             |            |
|-------------------------------------|------------------------------------|--------|------------------------------------|-----|-------------|------------|
|                                     | 2007                               |        | 2006                               |     | Variance \$ | Variance % |
| Amount                              | As a percentage of related revenue | Amount | As a percentage of related revenue |     |             |            |
| Selling, general and administrative | \$ 4,606                           | 28%    | \$ 3,476                           | 28% | \$ 1,130    | 33%        |
| Research and development            | 4,329                              | 26%    | 2,671                              | 21% | 1,658       | 62%        |
| Total operating expenses            | \$ 8,935                           | 54%    | \$ 6,147                           | 49% | \$ 2,788    | 45%        |

*Selling, general and administrative.* Selling, general and administrative expenses increased \$1.1 million from \$3.5 million for the three months ended September 30, 2006 to \$4.6 million for the three months ended

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September 30, 2007, representing a 33% increase. The increase in selling, general and administrative expenses are primarily attributable to an increase of \$453,000 of selling and marketing expenses including personnel expenses, \$325,000 of expenses associated with being a publicly traded company, primarily professional fees and \$235,000 in stock-based compensation expenses from options issued in 2007.

*Research and development.* Research and development expenses increased \$1.7 million from \$2.7 million for the three months ended September 30, 2006 to \$4.3 million for the three months ended September 30, 2007, representing a 62% increase. The increase in research and development expenses are principally attributable to a \$1.4 million increase in compensation and benefits and related overhead expenses resulting from an increase in our product development and product management activities related to our software products and an \$110,000 increase in stock-based compensation from options issued in 2007.

| (Dollars in thousands)              | Nine Months Ended September 30, |   |           |   |             |            |
|-------------------------------------|---------------------------------|---|-----------|---|-------------|------------|
|                                     | 2007                            |   | 2006      |   |             |            |
|                                     | Amount                          | As a<br>percentage of<br>related<br>revenue | Amount    | As a<br>percentage of<br>related<br>revenue | Variance \$ | Variance % |
| Selling, general and administrative | \$ 11,531                       | 26%   | \$ 10,047 | 31%   | \$ 1,484    | 15%        |
| Research and development            | 12,394                          | 28%   | 7,075     | 22%   | 5,319       | 75%        |
| Total operating expenses            | \$ 23,925                       | 54%   | \$ 17,122 | 52%   | \$ 6,803    | 40%        |

*Selling, general and administrative.* Selling, general and administrative expenses increased \$1.5 million from \$10.0 million for the nine months ended September 30, 2006 to \$11.5 million for the nine months ended September 30, 2007, representing a 15% increase. The increase in selling, general and administrative expenses are primarily attributable to an increase of \$504,000 in stock-based compensation expenses from options issued in 2007, \$325,000 of expenses associated with being a publicly traded company, primarily professional fees and \$208,000 of selling and marketing expenses including personnel expenses.

*Research and development.* Research and development expenses increased \$5.3 million from \$7.1 million for the nine months ended September 30, 2006 to \$12.4 million for the nine months ended September 30, 2007, representing a 75% increase. The increase in research and development expenses are principally attributable to a \$4.7 million increase in compensation and benefits and related overhead expenses resulting from an increase in our product development, product management activities related to our software products, a \$270,000 increase in stock-based compensation expense from options issued in 2007 and \$200,000 of third party professional fees.

### Interest income/(expense):

| (Dollars in thousands)              | Three Months Ended September 30, |        |  |  | Variance \$ | Variance % |
|-------------------------------------|----------------------------------|--------|--|--|-------------|------------|
|                                     | 2007                             | 2006   |  |  |             |            |
|                                     | Amount                           | Amount |  |  |             |            |
| Interest income                     | \$ 506                           | \$ 498 |  |  | \$ 8        | 2%         |
| Interest and deferred finance costs | (411)                            | -      |  |  | (411)       | n/a        |
|                                     | \$ 95                            | \$ 498 |  |  | \$ (403)    | -81%       |

Interest income was relatively unchanged for the three months ended September 30, 2006 compared to the three months ended September 30, 2007. Interest expense was \$411,000 for the three months ended September 30, 2007 as compared to \$0 for the three months ended September 30, 2006. The increase was primarily the result of expensing \$397,000 deferred financing costs resulting from the retirement of the \$20 million term loan.

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| (Dollars in thousands)              | Nine Months Ended September 30, |                | Variance \$ | Variance % |
|-------------------------------------|---------------------------------|----------------|-------------|------------|
|                                     | 2007<br>Amount                  | 2006<br>Amount |             |            |
| Interest income                     | \$ 1,101                        | \$ 1,405       | \$ (304)    | -22%       |
| Interest and deferred finance costs | (869)                           |                | (869)       | n/a        |
|                                     | \$ 232                          | \$ 1,405       | \$ (1,173)  | -83%       |

Interest income decreased \$304,000 from \$1.4 million for the nine months ended September 30, 2006 to \$1.1 million for the nine months ended September 30, 2007, representing a 22% decrease. The decrease was the result of the interest earned on a smaller average cash and cash equivalent balances due to the redemption of the preferred stock in the amount of \$17.3 million and the payment of a one-time cash dividend of \$41.3 million to all common stockholders in March 2007. Interest expense was \$869 for the nine months ended September 30, 2007 as compared to \$0 for the nine months ended September 30, 2006. The increase was primarily the result of the interest on the \$20.0 million term loan and the expensing \$397,000 of deferred financing costs resulting from the retirement of the \$20 million term loan.

**Income tax provision (benefit):**

| (Dollars in thousands) | Three Months Ended September 30, |                | Variance \$ | Variance % |
|------------------------|----------------------------------|----------------|-------------|------------|
|                        | 2007<br>Amount                   | 2006<br>Amount |             |            |
| Effective tax rate     |                                  |                | -19%        | 20%        |
| Income tax provision   | \$                               | \$ (552)       | \$          | 520        |

Our income tax provision decreased \$1.1 million from \$520,000 for the three months ended September 30, 2006 to a benefit of \$552,000 for the three months ended September 30, 2007, representing a 206% decrease. Included in our tax expense for the third quarter of 2007 is a benefit of \$1.1 million due to the reversal of a valuation allowance previously recorded against our deferred tax assets. The reversal is the result of our conclusion that it is more likely than not that the associated deferred tax assets will be realized. Without this reversal our effective tax rate would have been 20%. Our effective tax rate historically has been lower than the statutory rate of 34% largely due to the application of general business tax credits, and we expect to continue to benefit from these credits for the foreseeable future.

| (Dollars in thousands) | Nine Months Ended September 30, |                | Variance \$ | Variance % |
|------------------------|---------------------------------|----------------|-------------|------------|
|                        | 2007<br>Amount                  | 2006<br>Amount |             |            |
| Effective tax rate     |                                 |                | 5%          | 20%        |
| Income tax provision   | \$                              | \$ 398         | \$          | 1,151      |

Our income tax provision decreased \$753,000 from \$1.2 million for the nine months ended September 30, 2006 to \$398,000 for the nine months ended September 30, 2007, representing a 65% decrease. Included in our tax expense for the third quarter of 2007 is a benefit of \$1.1 million due to the reversal of a valuation allowance previously recorded against our deferred tax assets. The reversal is the result of our conclusion that it is more likely than not that the associated deferred tax assets will be realized. Without this reversal our effective tax rate would have been



20%. Our effective tax rate historically has been lower than the statutory rate of 34% largely due to the application of general business tax credits, and we expect to continue to benefit from these credits for the foreseeable future.

### Liquidity and Capital Resources

At September 30, 2007, we had \$40.0 million of cash and cash equivalents and working capital of \$28.1 million as compared to \$42.5 million of cash and cash equivalents and \$27.6 million in working capital at December 31, 2006. Historically, we have financed our operations through cash flow from operations. We believe that our existing cash and cash equivalents and our cash flow from future operating activities will be sufficient to meet our anticipated cash needs for the next twelve months. During July 2007, we completed our initial public offering of 5,118,750 million shares of our common stock and received net proceeds of \$52.4 million which excludes additional underwriter's cost of \$3.9 million. For additional information regarding our initial public offering see Note 1 to the Notes to Condensed Consolidated Financial Statements included under Item 1 of this current report on Form 10-Q.

| (Dollars in thousands)                    | Nine Months Ended September 30, |          |
|---|---------------------------------|----------|
|   | 2007                            | 2006     |
| Net cash provided by operating activities | \$ 6,758                        | \$ 6,430 |
| Net cash used in investing activities     | (1,656)                         | (749)    |
| Net cash used in financing activities     | (7,631)                         | (8,385)  |
| Cash and cash equivalents (end of period) | 40,012                          | 35,786   |

#### *Cash Flows from Operating Activities*

Net cash provided by operating activities for the nine months ended September 30, 2007 was \$6.8 million and \$6.4 million for the prior year period. This increase was primarily due to an increase in net income and stock-based compensation expenses offset by timing of cash receipts and disbursements between periods.

#### *Cash Flows from Investing Activities*

Net cash used in investing activities was \$1.7 million for the nine months ended September 30, 2007 and \$0.7 million in prior year period. This increase was primarily due to an increase in the purchases of property and equipment, consisting primarily of leasehold improvements, computer hardware and software.

#### *Cash Flows from Financing Activities*

Net cash used in financing activities was \$7.6 million for the nine months ended September 30, 2007 and \$8.4 million in the prior year period. This change was attributable primarily to the payment of dividends on common stock of \$41.3 million, the redemption of redeemable preferred stock of \$9.0 million, initial public offering and deferred financing costs of \$1.9 million offset by \$52.4 of proceeds from the initial public offering and \$0.5 million of exercise stock option costs.

### **Off-Balance Sheet Arrangements**

We do not have any relationships with unconsolidated entities or financial partnerships, such as variable interest entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes.

### **Available Information**

Our internet website address is <http://www.prospricing.com>. Our current reports on Form 8-K and any amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934 are available through the investor relations page of our internet website free of charge as soon as reasonably practicable after we electronically file such material with, or furnish it to, the SEC. Our internet website and the information contained therein or connected thereto are not intended to be incorporated into this Quarterly Report on Form 10-Q.

### **Item 3. Quantitative and Qualitative Disclosures About Market Risk**

#### *Interest Rate Sensitivity*

We had unrestricted cash and cash equivalents totaling \$40.0 million at September 30, 2007. These amounts were invested primarily in money market funds. The unrestricted cash and cash equivalents are held for working capital purposes. We do not enter into investments for trading or speculative purposes. Due to the short-term nature of these investments, we believe that we do not have any material exposure to changes in the fair value of our investment portfolio as a result of changes in interest rates. Declines in interest rates, however, will reduce future investment income, if any.

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

Our management evaluated, with the participation of our chief executive officer and our chief financial officer, the effectiveness of our disclosure controls and procedures 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 our chief financial officer have concluded that our disclosure controls and procedures are effective to ensure that information we are required to disclose in reports that we file or submit under the Securities Exchange Act of 1934 (i) is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms, and (ii) is accumulated and communicated to our management, including our chief executive officer and our chief financial officer, as appropriate to allow timely decisions regarding required disclosure. Our disclosure controls and procedures are designed to provide reasonable assurance that such information is accumulated and communicated to our management.

There have been no changes in the Company's internal control over financial reporting that occurred during the Company's last fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

It should be noted that in designing and evaluating our disclosure controls and procedures, our management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met due to numerous factors, ranging from errors to conscious acts of an individual, or individuals acting together. In addition, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of inherent limitations in a cost-effective control system, misstatements due to error and/or fraud may occur and

not be detected.

We are required to comply with Section 404 of the Sarbanes-Oxley Act of 2002 by our fiscal year ending December 31, 2008. The notification of such compliance is due no later than the time we file our annual report for the fiscal year ending December 31, 2008. We believe we will have adequate resources and expertise, both internal and external, in place to meet this requirement. However, there is no guarantee that our efforts will result in management's ability to conclude, or our independent registered public accounting firm to attest, that our internal control over financial reporting is effective as of December 31, 2008.

## **PART II. OTHER INFORMATION**

### **Item 1. Legal Proceedings**

We are not a party to any material legal proceedings. We could become involved in litigation from time to time relating to claims arising out of our ordinary course of business.

### **Item 1A. Risk Factors**

In addition to the other information set forth in this report, you should carefully consider the risk factors discussed in our prospectus dated June 27, 2007 and filed with the SEC on June 28, 2007, which are incorporated herein by reference and could materially affect our business, financial condition or future results. Such risk factors include, without limitation, the following:

We focus exclusively on the pricing and revenue optimization software market, and if this market develops more slowly than we expect, our business will be harmed.

Any downturn in our sales to airlines or any failure to increase sales to other industries would adversely affect our operating results.

Deterioration of general economic conditions could adversely affect our sales and operating results.

Our software products require implementation projects that are subject to significant risks, the materialization of which could negatively impact the effectiveness of our solutions, resulting in harm to our reputation, business and financial performance.

Our revenue recognition is primarily based upon our ability to estimate the efforts required to complete our implementation projects, which may be difficult to estimate.

If our cost estimates for fixed-fee arrangements do not accurately anticipate the cost and complexity of implementing our software products, our profitability could be reduced and we could experience losses on these arrangements.

We might not generate increased business from our current customers, which could limit our revenue in the future.

If we fail to develop or acquire new pricing and revenue optimization functionality to enhance our existing software products, we will not be able to achieve our anticipated level of growth.

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Competition from vendors of pricing solutions and enterprise applications as well as from companies internally developing their own solutions could adversely affect our ability to sell our software products and could result in pressure to price our software products in a manner that reduces our margins and harms our operating results.

We are subject to a lengthy sales cycle and delays or failures to complete sales may harm our business and cause our revenue and operating income to decline in the future.

If we fail to retain our key personnel or if we fail to attract additional qualified personnel, we will not be able to achieve our anticipated level of growth and our operating results could be adversely affected.

Our revenue recognition policy may cause any decreases in sales not to be reflected in our revenue immediately.

Our license and implementation revenue produces lower gross margins than our maintenance and support revenue, and an increase in license and implementation revenue relative to maintenance and support revenue may harm our overall gross margins.

Our international sales subject us to risks that may adversely affect our operating results.

Our inability to sustain our historical maintenance and support renewal rates and pricing would adversely affect our operating result.

We might not be able to manage our future growth efficiently or profitably.

Defects or errors in our software products could harm our reputation, impair our ability to sell our products and result in significant costs to us.

New accounting standards or interpretations of existing accounting standards, including those related to revenue recognition, could adversely affect our operating results.

If we fail to protect our proprietary rights and intellectual property adequately, our business and prospects may be harmed.

Intellectual property litigation and infringement claims may cause us to incur significant expense or prevent us from selling our software products.

We use open source software in our products that may subject our software products to general release or require us to re-engineer our products, which may cause harm to our business.

We utilize third-party software that we incorporate into our software products and impaired relations with these third parties, defects in third-party software or a third party's inability or failure to enhance their software over time could adversely affect our operating performance and financial condition.

The elimination or significant reduction in the general business tax credit could adversely affect our results of operations.

If we do not develop relationships with third-party consultants and systems integrators to implement our solutions, our growth may suffer.

We may enter into acquisitions that may be difficult to integrate, fail to achieve our strategic objectives, disrupt our business, dilute stockholder value or divert management attention.

Our operations might be affected by the occurrence of a natural disaster or other catastrophic event in Houston, Texas.

We will incur significant increased costs as a result of operating as a public company, and our management will be required to devote substantial time to new compliance initiatives.

Our ability to raise capital in the future may be limited, and our failure to raise capital when needed could prevent us from executing our growth strategy.

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

### *Use of Proceeds from Public Offering of Common Stock*

On July 3, 2007, we completed our Initial Public Offering pursuant to a registration statement on Form S-1 (Registration No. 333-141884) which the U.S. Securities and Exchange Commission declared effective on June 27, 2007. Under the registration statement, we registered the offering and sale of an aggregate of 5,118,750 shares of our common stock, and another 1,706,250 shares of our common stock sold by certain selling stockholders. All of the shares of common stock issued pursuant to the registration statement, including the shares sold by the selling stockholders, were sold at a price to the public of \$11.00 per share. The managing underwriters were J.P. Morgan Securities, Inc., Deutsche Bank Securities Inc. Jefferies & Company, Inc. and Thomas Weisel Partners LLC.

We raised a total of \$56,306,250 in gross proceeds from the IPO, and \$52,364,813 in net proceeds after deducting underwriting discounts and commissions of \$3,941,437. We did not receive any proceeds from the sale of shares in the IPO by the selling stockholders. No direct or

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indirect payments of offering expenses were paid to any of our directors or officers (or their associates) or person owning ten percent or more of our equity securities or to any other affiliates. On July 3, 2007 we used \$20,066,000 of the proceeds from our IPO to retire the remaining \$19,950,000 principle balance of the credit facility and related accrued interest in the amount of \$116,000.

We anticipate that we will use the remaining net proceeds from the IPO for the payment of IPO related expenses and for general corporate purposes. Pending such uses, we plan to invest the net proceeds in short-term, interest-bearing, investment grade securities.

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

None.

### **Item 4. Submission of Matters to a Vote of Security Holders.**

None.

**Item 5. Other Information.**

None.

**Item 6. Exhibits.**

**Index to exhibits**

- 3.1 Amended and Restated Certificate of Incorporation currently in effect (filed as Exhibit 3.1.1 to the Registrant's Registration Statement on Form S-1 (Securities and Exchange Commission File No. 333-94853), as amended (the IPO Registration Statement)).
- 3.2 Amended and Restated Bylaws currently in effect (filed as Exhibit 3.2.1 to the IPO Registration Statement).
- 4.1 Specimen certificate for shares of common stock (filed as Exhibit 4.1 to the IPO Registration Statement).
- 10.1 1997 Stock Option Plan, as amended to date, and form of stock option agreement (filed as Exhibit 10.1 to the IPO Registration Statement)
- 10.2 1999 Equity Incentive Plan, as amended to date, and form of stock option agreement (filed as Exhibit 10.2 to the IPO Registration Statement)
- 10.3 2007 Equity Incentive Plan and form of stock option agreement (filed as Exhibit 10.3 to the IPO Registration Statement)
- 10.4 Stock Purchase and Stockholders Agreement, dated June 8, 1998, by and among Registrant (as successor in interest to PROS Strategic Solutions, Inc.) and certain stockholders (filed as Exhibit 10.4 to the IPO Registration Statement)
- 10.4.1 Amendment to Stock Purchase and Stockholders Agreement dated March 26, 2007 by and among Registrant (as successor in interest to PROS Strategic Solutions, Inc.) and certain stockholders (filed as Exhibit 10.4.1 to the IPO Registration Statement)
- 10.5 Amended and Restated Stockholders Agreement, dated June 8, 1998, by and among Registrant (as successor in interest to PROS Strategic Solutions, Inc.) and certain stockholders (filed as Exhibit 10.5 to the IPO Registration Statement)
- 10.5.1 First Amendment to Amended and Restated Stockholders Agreement, dated April 8, 1999, by and among Registrant (as successor in interest to PROS Strategic Solutions, Inc.) and certain stockholders (filed as Exhibit 10.5.1 to the IPO Registration Statement)
- 10.6 Registration Rights Agreement, dated May 25, 1999, by and between Registrant (as successor in interest to PROS Strategic Solutions, Inc.) and David Samuel Coats (filed as Exhibit 10.6 to the IPO Registration Statement)
- 10.7 Registration Rights Agreement, dated April 13, 2000, by and between Registrant (as successor in interest to PROS Strategic Solutions, Inc.) and Robert Salter (filed as Exhibit 10.7 to the IPO Registration Statement)
- 10.8 Registration Rights Agreement, dated June 8, 2007, by and among Registrant, Mariette M. Woestemeyer and Ronald F. Woestemeyer (filed as Exhibit 10.8 to the IPO Registration Statement)
- 10.9 Redemption Agreement, dated March 26, 2007, by and among Registrant and the holders of the Company's redeemable preferred stock (filed as Exhibit 10.9 to the IPO Registration Statement)



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10.10 Office Lease, dated January 31, 2001, by and between PROS Revenue Management L.P. and Houston Community College System (filed as Exhibit 10.10 to the IPO Registration Statement)

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- 10.10.1 First Amendment to Office Lease, dated May 31, 2006, by and between PROS Revenue Management L.P. and Houston Community College System (filed as Exhibit 10.10.1 to the IPO Registration Statement)
- 10.11 Employment Agreement, dated September 30, 2005, by and between PROS Revenue Management L.P. and Albert Winemiller (filed as Exhibit 10.11 to the IPO Registration Statement)
- 10.11.1 Immediately Exercisable Stock Option Grant, dated April 2, 2007, by and between Registrant and Albert Winemiller (filed as Exhibit 10.11.1 to the IPO Registration Statement)
- 10.11.2 Amendment No. 1 to Employment Agreement, dated April 2, 2007, by and between Registrant and Albert Winemiller (filed as Exhibit 10.11.2 to the IPO Registration Statement)
- 10.12 Employment Agreement, dated September 30, 2005, by and between PROS Revenue Management L.P. and Charles Murphy (filed as Exhibit 10.12 to the IPO Registration Statement)
- 10.12.1 Immediately Exercisable Incentive Stock Option Grant, dated September 30, 2005, by and between Registrant and Charles Murphy (filed as Exhibit 10.12.1 to the IPO Registration Statement)
- 10.12.2 Immediately Exercisable Stock Option Grant, dated April 2, 2007, by and between Registrant and Charles Murphy (filed as Exhibit 10.12.2 to the IPO Registration Statement)
- 10.12.3 Amendment No. 1 to Employment Agreement, dated April 2, 2007, by and between Registrant and Charles Murphy (filed as Exhibit 10.12.3 to the IPO Registration Statement)
- 10.13 Employment Agreement, dated January 15, 1999, by and between PROS Revenue Management L.P. and Ronald Woestemeyer (filed as Exhibit 10.13 to the IPO Registration Statement)
- 10.13.1 Amendment No. 1 to Employment Agreement, dated February 2, 2004, by and between PROS Revenue Management L.P. and Ronald Woestemeyer (filed as Exhibit 10.13.1 to the IPO Registration Statement)
- 10.14 Form of Indemnification Agreement entered into among Registrant, its affiliates and its directors and officers (filed as Exhibit 10.16 to the IPO Registration Statement)
- 31.1# Certification of Chief Executive Officer Pursuant to Exchange Act Rule 13a-14(a) or 15d-14(a), as Adopted Pursuant to Section 302 of the Sarbanes Oxley Act of 2002.
- 31.2# Certification of Chief Financial Officer Pursuant to Exchange Act Rule 13a-14(a) or 15d-14(a), as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1# Certifications of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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# Filed with this report.

**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.

PROS HOLDINGS, INC.

Date November 2, 2007

By:

/s/ Albert E. Winemiller  
Albert E. Winemiller  
President and Chief Executive Officer

Date: November 2, 2007

By:

/s/ Charles H. Murphy  
Charles H. Murphy  
Executive Vice President and Chief Financial Officer