

BLACKBAUD INC

Form 10-Q

August 03, 2018

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

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

For the quarterly period ended **June 30, 2018**

or

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_.

Commission file number: **000-50600**

**Blackbaud, Inc.**

(Exact name of registrant as specified in its charter)

**Delaware**

(State or other jurisdiction of incorporation or organization)

**65 Fairchild Street**

**11-2617163**

(I.R.S. Employer Identification No.)

**Charleston, South Carolina 29492**

(Address of principal executive offices, including zip code)

**(843) 216-6200**

(Registrant's telephone number, including area code)

**2000 Daniel Island Drive**

**Charleston, South Carolina 29492**

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

YES  NO

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

YES  NO

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

Large accelerated filer	<input checked="" type="checkbox"/>	Accelerated filer	<input type="checkbox"/>
Non-accelerated filer	<input type="checkbox"/>	Smaller reporting company	<input type="checkbox"/>
	(Do not check if a smaller reporting company)	Emerging growth company	<input type="checkbox"/>

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

Indicate by check mark whether registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

YES  NO

The number of shares of the registrant's Common Stock outstanding as of July 25, 2018 was 48,584,111.

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# TABLE OF CONTENTS

<b><u>CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS</u></b>	<b><u>2</u></b>
<b><u>PART I. FINANCIAL INFORMATION</u></b>	<b><u>3</u></b>
<u>Item 1. Financial statements</u>	
<u>Consolidated balance sheets (unaudited)</u>	<u>3</u>
<u>Consolidated statements of comprehensive income (unaudited)</u>	<u>4</u>
<u>Consolidated statements of cash flows (unaudited)</u>	<u>5</u>
<u>Consolidated statement of stockholders' equity (unaudited)</u>	<u>6</u>
<u>Notes to consolidated financial statements (unaudited)</u>	<u>7</u>
<u>Item 2. Management's discussion and analysis of financial condition and results of operations</u>	<u>24</u>
<u>Item 3. Quantitative and qualitative disclosures about market risk</u>	<u>41</u>
<u>Item 4. Controls and procedures</u>	<u>42</u>
<b><u>PART II. OTHER INFORMATION</u></b>	<b><u>43</u></b>
<u>Item 1A. Risk factors</u>	<u>43</u>
<u>Item 2. Unregistered sales of equity securities and use of proceeds</u>	<u>43</u>
<u>Item 6. Exhibits</u>	<u>44</u>
<b><u>SIGNATURES</u></b>	<b><u>45</u></b>

**Table of Contents**

**Blackbaud, Inc.**

# **CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS**

This Quarterly Report on Form 10-Q, including the documents incorporated herein by reference, contains forward-looking statements that anticipate results based on our estimates, assumptions and plans that are subject to uncertainty. These "forward-looking statements" are made subject to the safe-harbor provisions 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. Forward-looking statements consist of, among other things, trend analyses, statements regarding future events, future financial performance, our anticipated growth, the effect of general economic and market conditions, our business strategy and our plan to build and grow our business, our operating results, our ability to successfully integrate acquired businesses and technologies, the effect of foreign currency exchange rate and interest rate fluctuations on our financial results, the impact of expensing stock-based compensation, the sufficiency of our capital resources, our ability to meet our ongoing debt and obligations as they become due, and potential litigation involving us, all of which are based on current expectations, estimates, and forecasts, and the beliefs and assumptions of our management. Words such as "believes," "seeks," "expects," "may," "might," "should," "intends," "could," "would," "likely," "will," "targets," "plans," "anticipates," "aims," "projects" or any variations of such words and similar expressions are also intended to identify such forward-looking statements. These forward-looking statements are subject to risks, uncertainties and assumptions that are difficult to predict. Accordingly, they should not be viewed as assurances of future performance, and actual results may differ materially and adversely from those expressed in any forward-looking statements. Important factors that could cause actual results to differ materially from our expectations expressed in forward-looking statements include, but are not limited to, those summarized under "Item 1A. Risk factors" and elsewhere in this report, in our Annual Report on Form 10-K for the year ended December 31, 2017 and in our other SEC filings. Forward-looking statements represent our management's beliefs and assumptions only as of the date of this Quarterly Report on Form 10-Q. We undertake no obligation to update or revise any forward-looking statements, or to update the reasons actual results could differ materially from those anticipated in any forward-looking statement, whether as a result of new information, future events or otherwise.

2 Second Quarter 2018 Form 10-Q

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# PART I. FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS

### Blackbaud, Inc. Consolidated balance sheets (Unaudited)

#### Assets

Current assets:		
Cash and cash equivalents	\$ 29,194	\$ 29,830
Restricted cash due to customers	295,463	610,344
Accounts receivable, net of allowance of \$5,501 and \$5,141 at June 30, 2018 and December 31, 2017, respectively	130,509	95,679
Customer funds receivable	5,528	1,536
Prepaid expenses and other current assets	75,816	61,978
Total current assets	536,510	799,367
Property and equipment, net	44,531	42,243
Software development costs, net	62,023	54,098
Goodwill	547,312	530,249
Intangible assets, net	317,220	314,651
Other assets	64,089	57,238
<b>Total assets</b>	<b>\$ 1,571,685</b>	<b>\$ 1,797,846</b>

#### Liabilities and stockholders' equity

Current liabilities:		
Trade accounts payable	\$ 31,141	\$ 24,693
Accrued expenses and other current liabilities	46,182	54,399
Due to customers	300,991	611,880
Debt, current portion	8,576	8,576
Deferred revenue, current portion	306,365	275,063
Total current liabilities	693,255	974,611
Debt, net of current portion	471,236	429,648
Deferred tax liability	48,055	48,023
Deferred revenue, net of current portion	3,442	3,643
Other liabilities	7,474	5,632
<b>Total liabilities</b>	<b>1,223,462</b>	<b>1,461,557</b>
Commitments and contingencies (see Note 10)		
Stockholders' equity:		
Preferred stock; 20,000,000 shares authorized, none outstanding	—	—
Common stock, \$0.001 par value; 180,000,000 shares authorized, 59,301,209 and 58,551,761 shares issued at June 30, 2018 and December 31, 2017, respectively	59	59
Additional paid-in capital	375,949	351,042
Treasury stock, at cost; 10,735,926 and 10,475,794 shares at June 30, 2018 and December 31, 2017, respectively	(264,383)	(239,199)
Accumulated other comprehensive loss	(1,011)	(642)
Retained earnings	237,609	225,029
<b>Total stockholders' equity</b>	<b>348,223</b>	<b>336,289</b>
<b>Total liabilities and stockholders' equity</b>	<b>\$ 1,571,685</b>	<b>\$ 1,797,846</b>



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

Second Quarter 2018 Form 10-Q 3

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

<b>Revenue</b>				
Recurring	\$ 192,749	\$ 166,389	\$ 373,595	\$ 326,436
One-time services and other	20,923	25,200	44,261	50,225
<b>Total revenue</b>	<b>213,672</b>	<b>191,589</b>	<b>417,856</b>	<b>376,661</b>
<b>Cost of revenue</b>				
Cost of recurring	76,350	66,178	145,429	130,053
Cost of one-time services and other	18,822	20,817	37,780	42,424
<b>Total cost of revenue</b>	<b>95,172</b>	<b>86,995</b>	<b>183,209</b>	<b>172,477</b>
<b>Gross profit</b>	<b>118,500</b>	<b>104,594</b>	<b>234,647</b>	<b>204,184</b>
<b>Operating expenses</b>				
Sales, marketing and customer success	48,493	42,580	93,970	83,577
Research and development	25,297	22,870	51,255	45,576
General and administrative	28,447	21,882	53,498	43,805
Amortization	1,201	739	2,470	1,430
Restructuring	3,688	—	4,499	—
<b>Total operating expenses</b>	<b>107,126</b>	<b>88,071</b>	<b>205,692</b>	<b>174,388</b>
<b>Income from operations</b>	<b>11,374</b>	<b>16,523</b>	<b>28,955</b>	<b>29,796</b>
Interest expense	(4,303)	(3,216)	(7,820)	(5,593)
Other income, net	346	827	506	1,113
<b>Income before provision for income taxes</b>	<b>7,417</b>	<b>14,134</b>	<b>21,641</b>	<b>25,316</b>
Income tax provision (benefit)	825	3,105	(2,702)	1,145
<b>Net income</b>	<b>\$ 6,592</b>	<b>\$ 11,029</b>	<b>\$ 24,343</b>	<b>\$ 24,171</b>
<b>Earnings per share</b>				
Basic	\$ 0.14	\$ 0.24	\$ 0.52	\$ 0.52
Diluted	\$ 0.14	\$ 0.23	\$ 0.51	\$ 0.51
<b>Common shares and equivalents outstanding</b>				
Basic weighted average shares	47,222,657	46,662,481	47,121,692	46,584,263
Diluted weighted average shares	48,053,094	47,691,340	48,030,547	47,586,893
<b>Dividends per share</b>	<b>\$ 0.12</b>	<b>\$ 0.12</b>	<b>\$ 0.24</b>	<b>\$ 0.24</b>
<b>Other comprehensive (loss) income</b>				
Foreign currency translation adjustment	(8,817)	(349)	(2,380)	(197)
Unrealized gain (loss) on derivative instruments, net of tax	765	(4)	1,844	178
<b>Total other comprehensive loss</b>	<b>(8,052)</b>	<b>(353)</b>	<b>(536)</b>	<b>(19)</b>
<b>Comprehensive (loss) income</b>	<b>\$ (1,460)</b>	<b>\$ 10,676</b>	<b>\$ 23,807</b>	<b>\$ 24,152</b>

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

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

**Cash flows from operating activities**

Net income	\$ 24,343	\$ 24,171
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	39,847	36,481
Provision for doubtful accounts and sales returns	3,697	5,469
Stock-based compensation expense	24,953	20,129
Deferred taxes	1,121	(1,524 )
Amortization of deferred financing costs and discount	376	468
Other non-cash adjustments	(419 )	(540 )
Changes in operating assets and liabilities, net of acquisition and disposal of businesses:		
Accounts receivable	(38,092 )	(44,809 )
Prepaid expenses and other assets	(18,629 )	(3,262 )
Trade accounts payable	6,327	(3,951 )
Accrued expenses and other liabilities	(6,675 )	(8,467 )
Deferred revenue	29,545	30,386
<b>Net cash provided by operating activities</b>	<b>66,394</b>	<b>54,551</b>

**Cash flows from investing activities**

Purchase of property and equipment	(9,575 )	(5,666 )
Capitalized software development costs	(16,359 )	(13,614 )
Purchase of net assets of acquired companies, net of cash and restricted cash acquired	(45,315 )	(49,729 )
Purchase of derivative instruments	—	(516 )
<b>Net cash used in investing activities</b>	<b>(71,249 )</b>	<b>(69,525 )</b>

**Cash flows from financing activities**

Proceeds from issuance of debt	173,500	575,700
Payments on debt	(132,150 )	(529,169 )
Debt issuance costs	—	(3,085 )
Employee taxes paid for withheld shares upon equity award settlement	(25,184 )	(16,644 )
Proceeds from exercise of stock options	11	14
Change in due to customers	(309,189 )	(85,581 )
Change in customer funds receivable	(4,391 )	—
Dividend payments to stockholders	(11,653 )	(11,530 )
<b>Net cash used in financing activities</b>	<b>(309,056 )</b>	<b>(70,295 )</b>
Effect of exchange rate on cash, cash equivalents, and restricted cash	(1,606 )	(196 )
<b>Net decrease in cash, cash equivalents, and restricted cash</b>	<b>(315,517 )</b>	<b>(85,465 )</b>
<b>Cash, cash equivalents, and restricted cash, beginning of period</b>	<b>640,174</b>	<b>370,673</b>
<b>Cash, cash equivalents, and restricted cash, end of period</b>	<b>\$ 324,657</b>	<b>\$ 285,208</b>

The following table provides a reconciliation of cash and cash equivalents and restricted cash reported within the condensed consolidated balance sheets that sum to the total of the same such amounts shown above in the consolidated statements of cash flows:

Cash and cash equivalents	\$ 29,194	\$ 29,830
Restricted cash due to customers	295,463	610,344
Total cash, cash equivalents and restricted cash in the statement of cash flows	\$ 324,657	\$ 640,174

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



**Blackbaud, Inc.**  
**Consolidated statement of stockholders' equity**  
**(Unaudited)**

<b>Balance at December 31, 2017</b>	58,551,761	\$ 59	\$ 351,042	\$(239,199)	\$( 642 )	\$ 225,029	\$ 336,289
Net income	—	—	—	—	—	24,343	24,343
Payment of dividends	—	—	—	—	—	(11,653 )	(11,653 )
Exercise of stock options and stock appreciation rights and vesting of restricted stock units	320,163	—	11	—	—	—	11
Employee taxes paid for 260,132 withheld shares upon equity award settlement	—	—	—	(25,184 )	—	—	(25,184 )
Stock-based compensation	—	—	24,896	—	—	57	24,953
Restricted stock grants	506,191	—	—	—	—	—	—
Restricted stock cancellations	(76,906 )	—	—	—	—	—	—
Other comprehensive loss	—	—	—	—	(536 )	—	(536 )
Reclassification upon early adoption of ASU 2018-02	—	—	—	—	167	(167 )	—
<b>Balance at June 30, 2018</b>	59,301,209	\$ 59	\$ 375,949	\$(264,383)	\$( 1,011 )	\$ 237,609	\$ 348,223

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

**Table of Contents**

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

## **1. Organization**

We are the world's leading cloud software company powering social good. Serving the entire social good community—nonprofits, foundations, companies, education institutions, healthcare organizations and individual change agents—we connect and empower organizations to increase their impact through cloud software, services, expertise and data intelligence. Our portfolio is tailored to the unique needs of vertical markets, with solutions for fundraising and CRM, marketing, advocacy, peer-to-peer fundraising, corporate social responsibility, school management, ticketing, grantmaking, financial management, payment processing and analytics. Serving the industry for more than three decades, we are headquartered in Charleston, South Carolina and have operations in the United States, Australia, Canada and the United Kingdom. As of June 30, 2018, we had over 40,000 customers.

## **2. Basis of Presentation**

### **Unaudited interim consolidated financial statements**

The accompanying interim consolidated financial statements have been prepared pursuant to the rules and regulations of the United States Securities and Exchange Commission ("SEC") for interim financial reporting. These consolidated statements are unaudited and, in the opinion of management, include all adjustments (consisting of normal recurring adjustments and accruals) necessary to state fairly the consolidated balance sheets, consolidated statements of comprehensive income, consolidated statements of cash flows and consolidated statement of stockholders' equity, for the periods presented in accordance with accounting principles generally accepted in the United States ("GAAP"). The consolidated balance sheet at December 31, 2017, has been derived from the audited consolidated financial statements at that date. Operating results and cash flows for the six months ended June 30, 2018 are not necessarily indicative of the results that may be expected for the fiscal year ending December 31, 2018, or any other future period. Certain information and footnote disclosures normally included in annual financial statements prepared in accordance with GAAP have been omitted in accordance with the rules and regulations for interim reporting of the SEC. These interim consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2017, and other forms filed with the SEC from time to time.

### **Reclassifications**

Our revenue from "subscriptions" and "maintenance" and a portion of our "services and other" revenue have been combined within "recurring" revenue beginning in 2018. In order to provide comparability between periods presented, those amounts of revenue have been combined within "recurring" revenue in the previously reported consolidated statements of comprehensive income to conform to presentation of the current period. Similarly, "cost of subscriptions" and "cost of maintenance" and a portion of "cost of services and other" have been combined within "cost of recurring" in the previously reported consolidated statements of comprehensive income to conform to presentation of the current period. "Services and other" revenue has been renamed as "one-time services and other" and consists of revenue that did not meet the description of "recurring" revenue in the consolidated statements of

comprehensive income. "Cost of services and other" has been renamed as "cost of one-time services and other" and consists of costs that did not meet the description of those related to "recurring" revenue in the consolidated statements of comprehensive income.

**Basis of consolidation**

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

**Table of Contents****Blackbaud, Inc.  
Notes to consolidated financial statements (continued)  
(Unaudited)****Reportable segment**

We report our operating results and financial information in one operating and reportable segment. Our chief operating decision maker uses consolidated financial information to make operating decisions, assess financial performance and allocate resources. Our chief operating decision maker is our chief executive officer ("CEO").

**Recently adopted accounting pronouncements**

In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2014-09, *Revenue from Contracts with Customers (Topic 606)* ("ASU 2014-09"), which outlines a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers. ASU 2014-09 replaces most previous revenue recognition guidance in GAAP and requires the recognition of revenue when promised goods or services are transferred to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The standard also provides guidance on the recognition of costs related to obtaining and fulfilling customer contracts.

We adopted ASU 2014-09 as of January 1, 2018 utilizing the full retrospective method of transition, which requires that the standard be applied to all periods presented. The impact of adopting ASU 2014-09 on our total revenues for 2017 and 2016 was not material. The primary impacts of adopting ASU 2014-09 relate to the deferral of incremental commission and other costs of obtaining contracts with customers and the increase to the amortization period for those costs. Previously, we deferred only direct and incremental commission costs to obtain a contract and amortized those costs over the contract term, generally three years, as the revenue was recognized. Under the new standard, we defer all incremental commission and related fringe benefit costs to obtain a contract and amortize these costs in a manner that aligns with the expected period of benefit. We utilized the 'portfolio approach' practical expedient in ASC 606-10-10-4, which allows entities to apply the guidance to a portfolio of contracts with similar characteristics because the effects on the financial statements of this approach would not differ materially from applying the guidance to individual contracts. Using the 'portfolio approach' and taking into consideration our customer contracts, our technology and other factors, we determined the expected period of benefit to be five years. We do not generally pay commissions for contract renewals.

Select adjusted unaudited financial statement information, which reflects our adoption of ASU 2014-09 is set forth below.

**Consolidated balance sheets:**

Accounts receivable, net of allowance	\$ 96,293	\$ (614)	) \$ 95,679
Prepaid expenses and other current assets	\$ 56,099	\$ 5,879	\$ 61,978
Other assets	\$ 24,083	\$ 33,155	\$ 57,238
Deferred revenue, current portion	\$ 276,456	\$ (1,393)	) \$ 275,063
Deferred tax liability	\$ 37,597	\$ 10,426	\$ 48,023
Retained earnings	\$ 195,649	\$ 29,380	\$ 225,029





**Table of Contents****Blackbaud, Inc.  
Notes to consolidated financial statements (continued)  
(Unaudited)****Consolidated statements of comprehensive income:****Revenue**

Recurring	\$ 158,169	\$ 8,220	\$ 166,389	\$ 310,129	\$ 16,307	\$ 326,436
One-time services and other	34,026	(8,826)	) 25,200	65,687	(15,462)	) 50,225
Total revenue	\$ 192,195	\$ (606)	) \$ 191,589	\$ 375,816	\$ 845	\$ 376,661

**Cost of Revenue**

Recurring	\$ 63,236	\$ 2,942	\$ 66,178	\$ 124,144	\$ 5,909	\$ 130,053
One-time services and other	23,759	(2,942)	) 20,817	48,333	(5,909)	) 42,424
Total cost of revenue	\$ 86,995	\$ —	\$ 86,995	\$ 172,477	\$ —	\$ 172,477

**Operating expenses**

Sales, marketing and customer success	\$ 42,961	\$ (381)	) \$ 42,580	\$ 85,201	\$ (1,624)	) \$ 83,577
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**Net income**

	\$ 11,165	\$ (136)	) \$ 11,029	\$ 22,676	\$ 1,495	\$ 24,171
Basic earnings per share	\$ 0.24	\$ —	\$ 0.24	\$ 0.49	\$ 0.03	\$ 0.52
Diluted earnings per share	\$ 0.23	\$ —	\$ 0.23	\$ 0.48	\$ 0.03	\$ 0.51

(1) See the discussion of our reclassifications of previously reported revenue and costs of revenue above.

Our adoption of ASU 2014-09 had no impact on our net cash provided by or used in operating, investing or financing activities for any of the periods reported.

Except for the accounting policies for revenue recognition and deferred commissions (herein referred to as "costs of obtaining contracts") that were updated as a result of adopting ASU 2014-09, there have been no changes to our significant accounting policies described in the Annual Report on Form 10-K for the year ended December 31, 2017, filed with the SEC on February 20, 2018, that have had a material impact on our consolidated financial statements. In February 2018, the FASB issued ASU 2018-02, *Income Statement - Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income* ("ASU 2018-02"), which allows a reclassification from accumulated other comprehensive income to retained earnings for stranded tax effects resulting from the U.S. Tax Cuts and Jobs Act (the "Tax Act") signed into law in December 2017. We early adopted ASU 2018-02 effective January 1, 2018 and recorded an insignificant reclassification for the stranded tax effects resulting from the Tax Act from accumulated other comprehensive loss to retained earnings.

**Summary of significant accounting policies****Revenue Recognition**

Our revenue is primarily generated from the following sources: (i) charging for the use of our software solutions in cloud-based and hosted environments; (ii) providing payment and transaction services; (iii) providing software maintenance and support services; and (iv) providing professional services, including implementation, consulting, training, analytic and other services. Revenues are recognized when control of these services is transferred to our customers, in an amount that reflects the consideration we expect to be entitled to in exchange for those services.

We determine revenue recognition through the following steps:

- Identification of the contract, or contracts, with a customer;
- Identification of the performance obligations in the contract;
- Determination of the transaction price;
- Allocation of the transaction price to the performance obligations in the contract; and
- Recognition of revenue when, or as, we satisfy a performance obligation.

**Table of Contents**

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

*Recurring*

Recurring revenue represents stand-ready performance obligations in which we are making our solutions or services available to our customers continuously over time or the value of the contract renews. Therefore, recurring revenue is generally recognized over time on a ratable basis over the contract term, beginning on the date that the solution or service is made available to the customer. Our recurring revenue contracts are generally for a term of three years at contract inception with one to three-year renewals thereafter, billed annually in advance and non-cancelable.

Recurring revenue is comprised of fees for the use of our subscription-based software solutions, which includes providing access to cloud-based solutions, hosting services, online training programs, subscription-based analytic services, such as donor acquisitions and data enrichment, and payment services. Recurring revenue also includes fees from maintenance services for our on-premises solutions, services included in our renewable subscription contracts, subscription-based contracts for professional services and variable transaction revenue associated with the use of our solutions.

Our payment services are offered with the assistance of third-party vendors. In general, when we are the principal in a transaction based on the factors identified in ASC 606-10-55-36 through 55-40, we record the revenue and related costs on a gross basis. Otherwise, we net the cost of revenue associated with the service against the gross revenue (amount billed to the customer) and record the net amount as revenue. For payment and transaction services, we have the right to invoice the customer in an amount that directly corresponds with the value to the customer of our performance to date. Therefore, we recognize revenue for these services over time based on the amount billable to the customer in accordance with the 'as invoiced' practical expedient in ASC 606-10-55-18.

*One-time services and other*

One-time services and other revenue primarily consists of fees for one-time consulting, analytic and onsite training services.

We generally bill consulting services based on hourly rates plus reimbursable travel-related expenses. Fixed price consulting engagements are generally billed as milestones towards completion are reached. Revenue for all consulting services is recognized over time as the services are performed.

We generally recognize analytic services revenue from donor prospect research engagements, the sale of lists of potential donors, data enrichment engagements and benchmarking studies at a point in time (upon delivery).

In certain cases, we sell training at a fixed rate for each specific class at a per attendee price or at a packaged price for several attendees, and recognize the related revenue upon the customer attending and completing training.

*Contracts with multiple performance obligations*

Some of our contracts with customers contain multiple performance obligations. For these contracts, we account for individual performance obligations separately if they are distinct. The transaction price is allocated to the separate performance obligations on a relative standalone selling price basis. Standalone selling prices of our solutions and services are typically estimated based on observable transactions when the solutions or services are sold on a standalone basis.

Costs of obtaining contracts, contract assets and deferred revenue

We pay sales commissions at the time contracts with customers are signed or shortly thereafter, depending on the size and duration of the sales contract. Sales commissions and related fringe benefits earned by our sales force are considered incremental and recoverable costs of obtaining a contract with a customer. These costs are deferred and then amortized in a manner that aligns with the expected period of benefit, which we have determined to be five years. We determined the period of benefit by taking into consideration our customer contracts, including renewals, retention, our technology and other factors. We do not generally pay commissions for contract renewals. The related amortization expense is included in sales, marketing and customer success expense in our consolidated statements of comprehensive income.

Amounts recognized as revenue in excess of amounts billed are recorded as contract assets within prepaid expenses and other current assets on our consolidated balance sheets. To the extent that our customers are billed for our solutions and services in advance of us satisfying the related performance obligations, we record such amounts in deferred revenue.

Table of Contents**Blackbaud, Inc.****Notes to consolidated financial statements (continued)  
(Unaudited)****Recently issued accounting pronouncements**

In February 2016, the FASB issued ASU 2016-02, *Leases (Topic 842)* ("ASU 2016-02"). ASU 2016-02 will require lessees to record most leases on their balance sheets but recognize expenses in the income statement in a manner similar to current guidance. The updated guidance also eliminates certain real estate-specific provisions and changes the guidance on sale-leaseback transactions, initial direct costs and lease executory costs for all entities. For lessors, the standard modifies the classification criteria and the accounting for sales-type and direct financing leases. All entities will classify leases to determine how to recognize lease-related revenue and expense. Classification will continue to affect amounts that lessors record on the balance sheet. ASU 2016-02 is effective for annual periods beginning after December 15, 2018, and interim periods within those years. Early adoption is permitted. Upon adoption, entities will be required to use a modified retrospective approach. The modified retrospective approach includes a number of optional practical expedients that entities may elect to apply. We expect ASU 2016-02 will impact our consolidated financial statements and related disclosures. We are currently evaluating the extent of the impact and expect that most of our lease commitments will be subject to the updated guidance and recognized as lease liabilities and right-of-use assets on our consolidated balance sheets upon adoption.

**3. Business Combinations****Reeher acquisition**

On April 30, 2018, we acquired all of the outstanding equity securities, including all voting equity interests, of Reeher LLC, a Minnesota limited liability company ("Reeher"), pursuant to a securities purchase agreement. The acquisition expands our fundraising performance management capabilities and is intended to drive more effective fundraising and greater social good outcomes for our customers. We acquired the equity securities for an aggregate purchase price of \$41.3 million in cash, subject to certain adjustments set forth in the securities purchase agreement. The purchase price and related expenses were funded primarily through borrowings under the 2017 Credit Facility (as defined below). As a result of the acquisition, Reeher has become a wholly-owned subsidiary of ours. The operating results of Reeher have been included in our consolidated financial statements from the date of acquisition. During the three and six months ended June 30, 2018, we incurred insignificant acquisition-related expenses associated with the acquisition, which were recorded in general and administrative expense.

The fair values assigned to the assets acquired and liabilities assumed in the table below are based on our best estimates and assumptions as of the reporting date and are considered preliminary pending finalization. The estimates and assumptions are subject to change as we obtain additional information during the measurement period, which may be up to one year from the acquisition date. The assets and liabilities, pending finalization, include the valuation of intangible assets as well as the assumed deferred revenue and deferred income tax balances.

Net working capital, excluding deferred revenue	\$1,683
Property and equipment	755

Identifiable intangible assets	27,055
Deferred tax asset	713
Deferred revenue	(2,700 )
Goodwill	13,827
Total purchase price	\$41,333

The estimated fair value of accounts receivable acquired approximates the contractual value of \$1.1 million and \$11.8 million of the goodwill arising in the acquisition is deductible for income tax purposes. The estimated goodwill recognized is attributable primarily to the opportunities for expected synergies from combining the operations and assembled workforce of Reeher.

Table of Contents

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

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

Acquired technology	\$ 18,900	11
Customer relationships	7,000	10
In-process research and development	600	Indefinite
Marketing assets	480	3
Non-compete agreements	75	2
Total intangible assets	\$ 27,055	11

The estimated fair values of the intangible assets were based on variations of the income approach, which estimates fair value based upon the present value of cash flows that the assets are expected to generate, and which included the relief-from-royalty method, incremental cash flow method, including the comparative (with and without) method and multi-period excess earnings method, depending on the intangible asset being valued. The method of amortization of identifiable finite-lived intangible assets is based on the expected pattern in which the estimated economic benefits of the respective assets are consumed or otherwise used up. Customer relationships and acquired technology are being amortized on an accelerated basis. Marketing assets and non-compete agreements are being amortized on a straight-line basis.

We determined that the impact of this acquisition was not material to our consolidated financial statements; therefore, revenue and earnings since the acquisition date and pro forma information are not required or presented.

#### **4. Goodwill**

The change in goodwill during the six months ended June 30, 2018, consisted of the following:

<b>Balance at December 31, 2017</b>	\$ 530,249
Additions related to current year business combinations	18,417
Adjustments related to prior year business combinations	(141 )
Effect of foreign currency translation	(1,213 )
<b>Balance at June 30, 2018</b>	\$ 547,312

#### **5. Earnings Per Share**

We compute basic earnings per share by dividing net income available to common stockholders by the weighted average number of common shares outstanding during the period. Diluted earnings per share is computed by dividing net income available to common stockholders by the weighted average number of common shares and dilutive potential common shares outstanding during the period. Diluted earnings per share reflect the assumed exercise, settlement and vesting of all dilutive securities using the "treasury stock method" except when the effect is anti-dilutive. Potentially dilutive securities consist of shares issuable



upon the exercise of stock options, settlement of stock appreciation rights and vesting of restricted stock awards and units.

12 Second Quarter 2018 Form 10-Q

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Table of Contents

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

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

	Three months ended June 30,		Six months ended June 30,	
Numerator:				
Net income	\$ 6,592	\$ 11,029	\$ 24,343	\$ 24,171
Denominator:				
Weighted average common shares	47,222,465	46,762,481	47,121,692	46,584,263
Add effect of dilutive securities:				
Stock-based awards	830,437	1,028,859	908,855	1,002,630
Weighted average common shares assuming dilution	48,053,094	47,791,340	48,030,547	47,586,893
Earnings per share:				
Basic	\$ 0.14	\$ 0.24	\$ 0.52	\$ 0.52
Diluted	\$ 0.14	\$ 0.23	\$ 0.51	\$ 0.51
Anti-dilutive shares excluded from calculations of diluted earnings per share	—	—	37	5,515

## 6. Fair Value Measurements

We use a three-tier fair value hierarchy to measure fair value. This hierarchy prioritizes the inputs into three broad levels as follows:

Level 1 - Quoted prices for identical assets or liabilities in active markets;

Level 2 - Quoted prices for similar assets and liabilities in active markets, quoted prices for identical or similar assets in markets that are not active, and model-derived valuations in which all significant inputs and significant value drivers are observable in active markets; and

Level 3 - Valuations derived from valuation techniques in which one or more significant inputs are unobservable.

Table of Contents**Blackbaud, Inc.****Notes to consolidated financial statements (continued)  
(Unaudited)****Recurring fair value measurements**

Financial assets and liabilities measured at fair value on a recurring basis consisted of the following, as of the dates indicated below:

**Fair value as of June 30, 2018**

Financial assets:

Derivative instruments	\$-\$3,789	\$	-\$3,789
Total financial assets	\$-\$3,789	\$	-\$3,789

**Fair value as of December 31, 2017**

Financial assets:

Derivative instruments	\$-\$1,283	\$	-\$1,283
Total financial assets	\$-\$1,283	\$	-\$1,283

Our derivative instruments within the scope of ASC 815, *Derivatives and Hedging*, are required to be recorded at fair value. Our derivative instruments that are recorded at fair value include interest rate swaps.

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

We believe the carrying amounts of our cash and cash equivalents, restricted cash due to customers, accounts receivable, trade accounts payable, accrued expenses and other current liabilities and due to customers approximate their fair values at June 30, 2018 and December 31, 2017, due to the immediate or short-term maturity of these instruments.

We believe the carrying amount of our debt approximates its fair value at June 30, 2018 and December 31, 2017, as the debt bears interest rates that approximate market value. As LIBOR rates are observable at commonly quoted intervals, our debt is classified within Level 2 of the fair value hierarchy.

We did not transfer any assets or liabilities among the levels within the fair value hierarchy during the six months ended June 30, 2018. Additionally, we did not hold any Level 3 assets or liabilities during the six months ended June 30, 2018.

**Non-recurring fair value measurements**

Assets and liabilities that are measured at fair value on a non-recurring basis include intangible assets and goodwill, which are recognized at fair value during the period in which an acquisition is completed, from updated estimates and assumptions during the measurement period, or when they are considered to be impaired. These non-recurring fair value measurements, primarily for intangible assets acquired, are based on Level 3 unobservable inputs. In the event of an impairment, we determine the fair value of the goodwill and intangible assets using a discounted cash flow approach, which contains significant unobservable inputs and, therefore, is considered a Level 3 fair value measurement. The unobservable inputs in the analysis generally include future cash flow

projections and a discount rate.

There were no non-recurring fair value adjustments to intangible assets and goodwill during the six months ended June 30, 2018, except for an insignificant business combination accounting adjustment to the initial fair value estimates of the assets acquired and liabilities assumed at the acquisition date from updated information obtained during the measurement period. See Note 4 to these consolidated financial statements for additional details. The measurement period of a business combination may be up to one year from the acquisition date. We record any measurement period adjustments to the fair value of assets acquired and liabilities assumed, with the corresponding offset to goodwill.

14 Second Quarter 2018 Form 10-Q

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Table of Contents

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

**7. Consolidated Financial Statement Details**  
**Prepaid expenses and other assets**

Costs of obtaining contracts <sup>(1)</sup>	\$81,631	\$ 77,312
Prepaid software maintenance and subscriptions	23,856	17,402
Taxes, prepaid and receivable	14,531	10,548
Derivative instruments	3,789	1,283
Contract assets	3,933	3,136
Security deposits	2,741	2,305
Other assets	9,424	7,230
Total prepaid expenses and other assets	139,905	119,216
Less: Long-term portion	64,089	57,238
Prepaid expenses and other current assets	\$75,816	\$ 61,978

(1) Amortization expense from costs of obtaining contracts was \$17.6 million for the six months ended June 30, 2018.

**Accrued expenses and other liabilities**

Accrued bonuses	\$11,134	\$ 16,743
Accrued commissions and salaries	8,917	6,943
Lease incentive obligations	4,186	4,635
Customer credit balances	3,413	4,652
Deferred rent liabilities	4,678	4,548
Taxes payable	3,270	5,517
Unrecognized tax benefit	3,112	1,972
Accrued vacation costs	2,366	2,458
Accrued health care costs	2,885	2,615
Other liabilities	9,695	9,948
Total accrued expenses and other liabilities	53,656	60,031
Less: Long-term portion	7,474	5,632
Accrued expenses and other current liabilities	\$46,182	\$ 54,399

**Other income, net**

	Three months ended June 30,	Six months ended June 30,		
Interest income	\$277	\$210	\$669	\$378
Gain on derivative instrument	—	475	—	475
Loss on debt extinguishment	—	(162 )	—	(162 )
Other income (expense), net	69	304	(163 )	422
Other income, net	\$346	\$827	\$506	\$1,113



Table of Contents**Blackbaud, Inc.****Notes to consolidated financial statements (continued)  
(Unaudited)****8. Debt**

The following table summarizes our debt balances and the related weighted average effective interest rates, which includes the effect of interest rate swap agreements.

Credit facility:					
Revolving credit loans	\$ 188,100	\$ 143,000	3.58	% 2.84	%
Term loans	292,500	296,250	3.30	% 2.64	%
Other debt	1,076	1,076	4.50	% 4.50	%
Total debt	481,676	440,326	3.41	% 2.71	%
Less: Unamortized discount and debt issuance costs	1,864	2,102			
Less: Debt, current portion	8,576	8,576	3.49	% 3.03	%
Debt, net of current portion	\$ 471,236	\$ 429,648	3.41	% 2.71	%

In June 2017, we entered into a five-year \$700.0 million senior credit facility (the "2017 Credit Facility"). As of June 30, 2018, the required annual maturities related to the 2017 Credit Facility and other debt were as follows:

2018 - remaining	\$ 4,826
2019	7,500
2020	7,500
2021	7,500
2022	454,350
Thereafter	—
Total required maturities	\$ 481,676

**9. Derivative Instruments****Cash flow hedges**

We generally use derivative instruments to manage our variable interest rate risk. In July 2017, we entered into an interest rate swap agreement (the "July 2017 Swap Agreement"), which effectively converts portions of our variable rate debt under our credit facility to a fixed rate for the term of the July 2017 Swap Agreement. The notional value of the July 2017 Swap Agreement was \$150.0 million with an effective date beginning in July 2017 through July 2021. We designated the July 2017 Swap Agreement as a cash flow hedge at the inception of the contract.

In February 2018, we entered into an additional interest rate swap agreement (the "February 2018 Swap Agreement"), which effectively converts portions of our variable rate debt under our credit facility to a fixed rate for the term of the February 2018 Swap Agreement. The notional value of the February 2018 Swap Agreement was \$50.0 million with an effective date beginning in February 2018 through June 2021. We designated the February 2018 Swap

Agreement as a cash flow hedge at the inception of the contract.

16 Second Quarter 2018 Form 10-Q

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**Table of Contents**

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

**Undesignated contracts**

In June 2017, we entered into a foreign currency option contract to hedge our exposure to currency fluctuations in connection with our acquisition of JustGiving because the purchase price was denominated in British Pounds. The notional value of the instrument was £100.0 million with an effective date beginning in June 2017 and maturing in September 2017. We settled the foreign currency option contract in September 2017. We did not designate the foreign currency option contract as a cash flow hedge for accounting purposes since it involved a business combination. As such, changes in the fair value of this derivative were recognized in earnings. The insignificant premium paid for this option is shown within cash flows from investing activities in our consolidated statements of cash flows.

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

**Derivative instruments designated as hedging instruments:**

Interest rate swaps, current portion	Prepaid expenses and other current assets	\$—	\$ 145	Accrued expenses and other current liabilities	\$	-\$	—
Interest rate swaps, long-term portion	Other assets	3,789	1,138	Other liabilities	—	—	—
<b>Total derivative instruments designated as hedging instruments</b>		<b>\$ 3,789</b>	<b>\$ 1,283</b>		<b>\$</b>	<b>-\$</b>	<b>—</b>

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

Interest rate swaps \$ 3,789      Interest expense \$(60) \$(40 )

Interest rate swaps \$ 336      Interest expense \$15    \$(104 )

Our policy requires that derivatives used for hedging purposes be designated and effective as a hedge of the identified risk exposure at the inception of the contract. Accumulated other comprehensive income (loss) includes unrealized gains or losses from the change in fair value

measurement of our derivative instruments each reporting period and the related income tax expense or benefit. Changes in the fair value measurements of the derivative instruments and the related income tax expense or benefit are reflected as adjustments to accumulated other comprehensive income (loss) until the actual hedged expense is incurred or until the hedge is terminated at which point the unrealized gain (loss) is reclassified from accumulated other comprehensive income (loss) to current earnings. The estimated accumulated other comprehensive income as of June 30, 2018 that is expected to be reclassified into earnings within the next twelve months is \$0.7 million. There were no ineffective portions of our interest rate swap derivatives during the six months ended June 30, 2018 and 2017. See Note 13 to these consolidated financial statements for a summary of the changes in accumulated other comprehensive income (loss) by component.

We did not have any undesignated derivative instruments during 2018. The effects of undesignated derivative instruments during the three and six months ended June 30, 2017 were as follows:

Foreign currency option contracts	Other income (expense), net	\$ 475	\$ 475
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**Table of Contents**

**Blackbaud, Inc.**

**Notes to consolidated financial statements (continued)  
(Unaudited)**

**10. Commitments and Contingencies**

**Leases**

Total rent expense was \$5.0 million and \$4.1 million for the three months ended June 30, 2018 and 2017, respectively, and \$9.0 million and \$8.1 million, respectively, for the six months ended June 30, 2018 and 2017.

**Other commitments**

The term loans under the 2017 Credit Facility require periodic principal payments. The balance of the term loans and any amounts drawn on the revolving credit loans are due upon maturity of the 2017 Credit Facility in June 2022.

We have contractual obligations for third-party technology used in our solutions and for other services we purchase as part of our normal operations. In certain cases, these arrangements require a minimum annual purchase commitment by us. As of June 30, 2018, the remaining aggregate minimum purchase commitment under these arrangements was approximately \$48.2 million through 2023.

**Solution and service indemnifications**

In the ordinary course of business, we provide certain indemnifications of varying scope to customers against claims of intellectual property infringement made by third parties arising from the use of our solutions or services. If we determine that it is probable that a loss has been incurred related to solution or service indemnifications, any such loss that could be reasonably estimated would be recognized. We have not identified any losses and, accordingly, we have not recorded a liability related to these indemnifications.

**Legal proceedings**

We are subject to legal proceedings and claims that arise in the ordinary course of business. We make a provision for a loss contingency when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated. These provisions are reviewed at least quarterly and adjusted to reflect the impacts of negotiations, settlements, rulings, advice of legal counsel and other information and events pertaining to a particular case. Unless otherwise specifically disclosed in this note, we have determined as of June 30, 2018, that no provision for liability nor disclosure is required related to any claim against us because (a) there is not a reasonable possibility that a loss exceeding amounts already recognized (if any) may be incurred with respect to such claim; (b) a reasonably possible loss or range of loss cannot be estimated; or (c) such estimate is immaterial.

All legal costs associated with litigation are expensed as incurred. Litigation is inherently unpredictable. However, we believe that we have valid defenses with respect to the legal matters pending against us. It is possible, nevertheless, that our consolidated financial position, results of operations or cash flows could be negatively affected in any particular period by an unfavorable resolution of one or more of such proceedings, claims or investigations.

Table of Contents**Blackbaud, Inc.****Notes to consolidated financial statements (continued)  
(Unaudited)****11. Income Taxes**

Our income tax provision (benefit) and effective income tax rates, including the effects of period-specific events, were:

	Three months ended June 30,		Six months ended June 30,	
Income tax provision (benefit)	\$ 825	\$ 3,105	\$(2,702)	\$ 1,145
Effective income tax rate	11.1 %	22.0 %	(12.5 %)	4.5 %

The decreases in our effective income tax rates during the three and six months ended June 30, 2018, when compared to the same periods in 2017, were primarily due to the impact of the discrete benefit to income tax expense relating to stock-based compensation items, calculated prior to the impact of the U.S. federal corporate tax rate change as a result of the Tax Act. This favorable impact was attributable to an increase in the market price for shares of our common stock, as reported by the Nasdaq Stock Market LLC ("Nasdaq"), as well as an increase in the number of stock awards that vested and were exercised. Most of our equity awards are granted during our first quarter and vest in subsequent years during the same quarter. This discrete benefit to income tax expense relating to stock-based compensation during the three and six months ended June 30, 2018 was reduced as a result of the decrease in the U.S. corporate tax rate.

The decreases in our effective income tax rates during the three and six months ended June 30, 2018, as compared to the same periods in 2017, were also attributable to the impact of the lower U.S. federal corporate tax rate on pre-tax income.

In December 2017, the Tax Act was signed into law making significant changes to the Internal Revenue Code. Changes include, but are not limited to, a corporate tax rate decrease from 35% to 21% effective for tax years beginning after December 31, 2017, the transition of U.S. international taxation from a worldwide tax system to a territorial system, and a one-time transition tax on the mandatory deemed repatriation of cumulative foreign earnings as of December 31, 2017.

On December 22, 2017, Staff Accounting Bulletin No. 118 ("SAB 118") was issued to address the application of U.S. GAAP in situations when a registrant does not have the necessary information available, prepared or analyzed (including computations) in reasonable detail to complete the accounting for certain income tax effects of the Tax Act. For the three and six months ended June 30, 2018, the Company obtained additional information affecting the provisional amount calculated for the transition tax as of December 31, 2017; however, the Company determined that the transition tax is still insignificant.

The Tax Act eliminates the exceptions for performance-based compensation and CFO compensation from the 162(m) calculation. A transition rule allows for the grandfathering of performance-based compensation pursuant to a written binding contract in effect as of November 2, 2017. While there is negative discretion inherent in our performance-based

compensation plans, it is our position that the intent is for historic contracts to be written and binding. As a result, we have not adjusted the ending estimated deferred tax assets for the performance-based stock compensation or the bonus accrual in our 2018 tax provision.

Our estimates of the impact of the Tax Act may change due to a number of additional considerations including, but not limited to, the issuance of additional regulations or guidance and our ongoing analysis of the new law. Any subsequent adjustment to these amounts will be recorded to tax expense when the analysis is complete.

Table of Contents**Blackbaud, Inc.****Notes to consolidated financial statements (continued)  
(Unaudited)****12. Stock-based Compensation**

Stock-based compensation expense is allocated to cost of revenue and operating expenses on the consolidated statements of comprehensive income based on where the associated employee's compensation is recorded. The following table summarizes stock-based compensation expense:

	Three months ended June 30,		Six months ended June 30,	
Included in cost of revenue:				
Cost of recurring	\$ 718	\$ 443	\$ 1,170	\$ 823
Cost of one-time services and other	927	507	1,570	918
Total included in cost of revenue	1,645	950	2,740	1,741
Included in operating expenses:				
Sales, marketing and customer success	2,807	1,781	4,632	3,220
Research and development	2,448	2,067	4,584	3,784
General and administrative	6,961	6,037	12,997	11,384
Total included in operating expenses	12,216	9,885	22,213	18,388
Total stock-based compensation expense	\$ 13,861	\$ 10,835	\$ 24,953	\$ 20,129

**13. Stockholders' Equity****Dividends**

Our Board of Directors has adopted a dividend policy, which provides for the distribution to stockholders of a portion of cash generated by us that is in excess of operational needs and capital expenditures. The 2017 Credit Facility limits the amount of dividends payable and certain state laws restrict the amount of dividends distributed.

In February 2018, our Board of Directors approved an annual dividend rate of \$0.48 per share to be made in quarterly payments. Dividend payments are not guaranteed and our Board of Directors may decide, in its absolute discretion, at any time and for any reason, not to declare and pay further dividends. The following table provides information with respect to quarterly dividends of \$0.12 per share paid on common stock during the six months ended June 30, 2018.

February 6, 2018	\$ 0.12	February 28	March 15
April 30, 2018	\$ 0.12	May 25	June 15

On July 30, 2018, our Board of Directors declared a third quarter dividend of \$0.12 per share payable on September 14, 2018 to stockholders of record on August 28, 2018.

Table of Contents**Blackbaud, Inc.****Notes to consolidated financial statements (continued)  
(Unaudited)****Changes in accumulated other comprehensive income (loss) by component**

The changes in accumulated other comprehensive income (loss) by component, consisted of the following:

	Three months ended June 30,	Six months ended June 30,
<b>Accumulated other comprehensive income (loss), beginning of period</b>	\$7,041\$(270)	\$(642)\$