Paylocity Holding Corp
Form 10-Q
February 03, 2017
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 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 December 31, 2016

Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the transition period from to

Commission file number 001-36348

PAYLOCITY HOLDING CORPORATION

(Exact name of registrant as specified in its charter)

Delaware	46-4066644
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)

3850 N. Wilke Road

Arlington Heights, Illinois	60004
(Address of principal executive offices)	(Zip Code)

(847) 463-3200

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes 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 (§ 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, or a smaller reporting company. See the definitions of "large accelerated filer" "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large Accelerated Filer		Accelerated Filer
Non-Accelerated Filer	(Do not check if a smaller reporting company)	Smaller Reporting Company

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: 51,437,392 shares of Common Stock, $0.001 par value per share, as of January 27, 2017.

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Paylocity Holding Corporation

Form 10-Q

For the Quarterly Period Ended December 31, 2016

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PART I

FINANCIAL INFORMATION

Item 1. Financial Statements

PAYLOCITY HOLDING CORPORATION

Unaudited Consolidated Balance Sheets

(in thousands, except per share data)

	June 30, 2016	December 31, 2016
Assets		
Current assets:		
Cash and cash equivalents	$ 86,496	$ 82,257
Accounts receivable, net	1,681	2,067
Prepaid expenses and other	7,409	11,291
Total current assets before funds held for clients	95,586	95,615
Funds held for clients	1,239,622	1,092,471
Total current assets	1,335,208	1,188,086
Long-term prepaid expenses	845	618
Capitalized internal-use software, net	11,427	14,944
Property and equipment, net	26,787	33,633
Intangible assets, net	10,419	9,657
Goodwill	6,003	6,003
Total assets	$ 1,390,689	$ 1,252,941
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	$ 1,621	$ 3,134
Accrued expenses	24,979	22,096
Total current liabilities before client fund obligations	26,600	25,230

Client fund obligations	1,239,622	1,092,471
Total current liabilities	1,266,222	1,117,701
Deferred rent	4,646	9,548
Deferred income tax liabilities, net	249	351
Total liabilities	$ 1,271,117	$ 1,127,600
Stockholders' equity:		
Preferred stock, $0.001 par value, 5,000 authorized, no shares issued and outstanding at June 30, 2016 and December 31, 2016	$ —	$ —
Common stock, $0.001 par value, 155,000 shares authorized at June 30, 2016 and December 31, 2016; 51,132 shares issued and outstanding at June 30, 2016 and 51,430 shares issued and outstanding at December 31, 2016	51	51
Additional paid-in capital	171,515	181,523
Accumulated deficit	(51,994)	(56,233)
Total stockholders' equity	$ 119,572	$ 125,341
Total liabilities and stockholders' equity	$ 1,390,689	$ 1,252,941

See accompanying notes to unaudited consolidated financial statements.

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PAYLOCITY HOLDING CORPORATION

Unaudited Consolidated Statements of Operations

(in thousands, except per share data)

	Three months ended December 31, 2015	Three months ended December 31, 2016	Six months ended December 31, 2015	Six months ended December 31, 2016
Revenues:				
Recurring fees	$ 51,732	$ 65,347	$ 94,095	$ 127,267
Interest income on funds held for clients	615	731	1,143	1,448
Total recurring revenues	52,347	66,078	95,238	128,715
Implementation services and other	2,837	2,576	5,054	4,961
Total revenues	55,184	68,654	100,292	133,676
Cost of revenues:				
Recurring revenues	16,125	20,716	29,282	39,819
Implementation services and other	7,975	9,667	15,013	18,923
Total cost of revenues	24,100	30,383	44,295	58,742
Gross profit	31,084	38,271	55,997	74,934
Operating expenses:				
Sales and marketing	14,340	17,735	26,790	35,746
Research and development	6,799	7,222	12,228	14,523
General and administrative	11,239	14,957	21,690	28,815
Total operating expenses	32,378	39,914	60,708	79,084
Operating loss	(1,294)	(1,643)	(4,711)	(4,150)
Other income	214	4	297	43
Loss before income taxes	(1,080)	(1,639)	(4,414)	(4,107)
Income tax expense	85	32	186	132
Net loss	$ (1,165)	$ (1,671)	$ (4,600)	$ (4,239)
Net loss per share:				
Basic	$ (0.02)	$ (0.03)	$ (0.09)	$ (0.08)
Diluted	$ (0.02)	$ (0.03)	$ (0.09)	$ (0.08)

Weighted-average shares used in computing net loss per share:

Basic	50,890	51,384	50,817	51,308
Diluted	50,890	51,384	50,817	51,308

See accompanying notes to unaudited consolidated financial statements.

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PAYLOCITY HOLDING CORPORATION

Unaudited Consolidated Statement of Changes in Stockholders' Equity

(in thousands)

	Stockholders' Equity				
	Common Stock		Additional Paid-in	Accumulated	Total Stockholders'
	Shares	Amount	Capital	Deficit	Equity
Balances at June 30, 2016	51,132	$ 51	$ 171,515	$ (51,994)	$ 119,572
Stock-based compensation expense	—	—	13,320	—	13,320
Stock options exercised	191	—	2,633	—	2,633
Issuance of common stock upon vesting of restricted stock units	222	—	—	—	—
Issuance of common stock under employee stock purchase plan	64	—	1,823	—	1,823
Net settlement for taxes and/or exercise price related to equity awards	(179)	—	(7,768)	—	(7,768)
Net loss	—	—	—	(4,239)	(4,239)
Balances at December 31, 2016	51,430	$ 51	$ 181,523	$ (56,233)	$ 125,341

See accompanying notes to the unaudited consolidated financial statements.

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PAYLOCITY HOLDING CORPORATION

Unaudited Consolidated Statements of Cash Flows

(in thousands)

	Six Months Ended December 31, 2015	2016
Cash flows from operating activities:		
Net loss	$ (4,600)	$ (4,239)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Stock-based compensation expense	8,492	12,448
Depreciation and amortization expense	6,155	9,103
Deferred income tax expense	151	102
Provision for doubtful accounts	75	60
Loss on disposal of equipment	168	97
Changes in operating assets and liabilities:		
Accounts receivable	(428)	(446)
Prepaid expenses and other	(891)	845
Accounts payable	653	46
Accrued expenses	1,039	(2,626)
Net cash provided by operating activities	10,814	15,390
Cash flows from investing activities:		
Capitalized internal-use software costs	(3,775)	(6,279)
Purchases of property and equipment	(6,865)	(10,038)
Payments for acquisitions	(183)	—
Net change in funds held for clients	(291,918)	147,151
Net cash provided by (used in) investing activities	(302,741)	130,834
Cash flows from financing activities:		
Net change in client funds obligation	291,918	(147,151)
Proceeds from exercise of stock options	137	—
Proceeds from employee stock purchase plan	1,403	1,823
Taxes paid related to net share settlement of equity awards	(3,765)	(5,135)
Net cash provided by (used in) financing activities	289,693	(150,463)
Net Change in Cash and Cash Equivalents	(2,234)	(4,239)
Cash and Cash Equivalents—Beginning of Period	81,258	86,496
Cash and Cash Equivalents—End of Period	$ 79,024	$ 82,257
Supplemental Disclosure of Non-Cash Investing and Financing Activities		
Build-out allowances received from landlords	$ 55	$ —

Unpaid follow-on offering costs included in accrued expenses	$ 152	$ —
Purchase of property and equipment, accrued but not paid	$ 1,531	$ 2,172
Supplemental Disclosure of Cash Flow Information		
Cash paid for income taxes, net of refunds	$ 22	$ 26

See accompanying notes to unaudited consolidated financial statements.

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PAYLOCITY HOLDING CORPORATION

Notes to the Unaudited Consolidated Financial Statements

(all amounts in thousands, except per share data)

(1) Organization and Description of Business

Paylocity Holding Corporation (the "Company"), through its wholly owned subsidiary, Paylocity Corporation, is a cloud-based provider of payroll and human capital management software solutions for medium-sized organizations. Services are provided in a Software-as-a-Service ("SaaS") delivery model utilizing the Company's cloud-based platform. Payroll services include collection, remittance and reporting of payroll liabilities to the appropriate federal, state and local authorities.

(2) Summary of Significant Accounting Policies

(a) Consolidation and Use of Estimates

These unaudited consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles ("GAAP"). The unaudited consolidated financial statements include the accounts of the Company and its wholly owned subsidiary. All intercompany accounts and transactions have been eliminated in consolidation.

The preparation of consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Significant items subject to such estimates and assumptions include the allowance for doubtful accounts, internal-use software, valuation and useful lives of long-lived assets, definite-lived intangibles, goodwill, stock-based compensation, valuation of net deferred income tax assets and the best estimate of selling price for revenue recognition purposes. Future events and their effects cannot be predicted with certainty; accordingly, accounting estimates require the exercise of judgment. Accounting estimates used in the preparation of these consolidated financial statements change as new events occur, as more experience is acquired, as additional information is obtained and as the operating environment changes.

(b) Interim Unaudited Consolidated Financial Information

The accompanying unaudited consolidated financial statements and notes have been prepared in accordance with GAAP and applicable rules and regulations of the Securities and Exchange Commission ("SEC") regarding interim financial reporting. Accordingly, they do not include all of the information and notes required by GAAP for complete financial statements. In the opinion of management, the interim financial information includes all adjustments of a normal recurring nature necessary for a fair presentation of the Company's financial position, results of operations, changes in stockholders' equity and cash flows. The results of operations for the three and six months ended December 31, 2016 are not necessarily indicative of the results for the full year or the results for any future periods. These unaudited consolidated financial statements should be read in conjunction with the audited consolidated financial statements and related notes for the year ended June 30, 2016 included in the Company's Annual Report on Form 10-K filed with the SEC on August 12, 2016.

(c) Income Taxes

Differences in the normal relationship between the income tax expense and pre tax loss materially result from the existence of a valuation allowance recorded against the preponderance of the net deferred tax assets.

(d) Stock-Based Compensation

The Company recognizes all employee stock-based compensation as a cost in the financial statements. Equity-classified awards, including those under the 2014 Employee Stock Purchase Plan ("ESPP"), are measured at the grant date fair value of the award and expense is recognized, net of assumed forfeitures, on a straight-line basis over the requisite service period for each separately vesting portion of the award. The Company estimates grant date fair value

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using the Black-Scholes option-pricing model and periodically updates the assumed forfeiture rates for actual experience over the option vesting term or the term of the ESPP purchase period.

(e) Recently Issued Accounting Standards

In May 2014, the Financial Accounting Standards Board (FASB) issued ASU 2014-09, Revenue from Contracts with Customers (Topic 606) ("ASU 2014-09"). ASU 2014-09 supersedes a majority of existing revenue recognition guidance under US GAAP, and requires companies to recognize revenue when it transfers goods or services to a customer in an amount that reflects the consideration to which a company expects to be entitled. Companies may need to apply more judgment and estimation techniques or methods while recognizing revenue, which could result in additional disclosures to the financial statements. In addition, in March 2016, April 2016, May 2016 and December 2016 the FASB issued ASU 2016-08, Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net) ("ASU 2016-08"), ASU 2016-10, Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing ("ASU 2016-10"), ASU 2016-12, Revenue from Contracts with Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients ("ASU 2016-12") and ASU 2016-20, Technical Corrections and Improvements to Topic 606, Revenue from Contracts with Customers ("ASU 2016-20"), respectively, to amend certain guidance in ASU 2014-09. Topic 606 allows for either a retrospective or cumulative effect transition method. ASU 2014-09 was originally effective for fiscal years beginning after December 15, 2016. In July 2015, the FASB approved a one-year deferral of ASU 2014-09 and all amendments to it, with a new effective date for fiscal years beginning after December 15, 2017 with early adoption permitted as of the original effective date. The Company is currently assessing the potential effects of these changes to its consolidated financial statements and is evaluating the adoption method and timing of adoption.

In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842) ("ASU 2016-02") which amends various aspects of existing guidance for leases. ASU 2016-02 requires an entity to recognize assets and liabilities arising from a lease with terms greater than twelve months, along with additional qualitative and quantitative disclosures. ASU 2016-02 also requires the use of the modified retrospective method, which will require adjustment to all comparative periods presented. ASU 2016-02 is effective for fiscal years beginning after December 15, 2018, with early adoption permitted. The Company is currently assessing the potential effects of these changes to its consolidated financial statements and is evaluating the timing of adoption.

In March 2016, the FASB issued ASU 2016-09, Compensation – Stock Compensation (Topic 718) ("ASU 2016-09") which modifies the existing guidance for stock compensation specifically related to the accounting for excess tax benefits and tax deficiencies, forfeitures, and employer tax withholding requirements. ASU 2016-09 also clarifies certain classifications on the statement of cash flows. ASU 2016-09 is effective for fiscal years beginning after December 15, 2016, with early adoption permitted. The Company is currently assessing the potential effects of these changes to its consolidated financial statements and is evaluating the timing of adoption.

In June 2016, the FASB issued ASU 2016-13, Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments (“ASU 2016-13”), which requires measurement and recognition of expected credit losses for financial assets held. ASU 2016-13 is effective for fiscal years beginning after December 15, 2019, with early adoption permitted as of fiscal years beginning after December 15, 2018. The Company is currently assessing the potential effects of these changes to its consolidated financial statements and is evaluating the timing of adoption.

From time to time, new accounting pronouncements are issued by the FASB or other standard setting bodies that are adopted by the Company as of the specified effective date. Unless otherwise discussed, the Company believes that the impact of other recently issued standards that are not yet effective will not have a material impact on the Company’s consolidated financial statements upon adoption.

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(3) Balance Sheet Information

The following tables provide details of selected consolidated balance sheet items:

Activity in the allowance for doubtful accounts was as follows:

Balance at June 30, 2016	$ 193
Charged to expense	60
Write-offs	(9)
Balance at December 31, 2016	$ 244

Capitalized internal-use software and accumulated amortization were as follows:

	June 30, 2016	December 31, 2016
Capitalized internal-use software	$ 34,249	$ 41,400
Accumulated amortization	(22,822)	(26,456)
Capitalized internal-use software, net	$ 11,427	$ 14,944

Amortization of capitalized internal-use software costs is included in Cost of Revenues-Recurring Revenues and amounted to $1,423 and $1,950 for the three months ended December 31, 2015 and 2016, respectively, and $2,365 and $3,634 for the six months ended December 31, 2015 and 2016, respectively.

Property and equipment, net consist of the following:

	June 30, 2016	December 31, 2016
Office equipment	$ 2,528	$ 3,538

Computer equipment	18,139	22,882
Furniture and fixtures	4,308	5,490
Software	5,059	5,581
Leasehold improvements	11,164	13,895
Time clocks rented by clients	4,046	4,349
	45,244	55,735
Accumulated depreciation	(18,457)	(22,102)
Property and equipment, net	$ 26,787	$ 33,633

Depreciation expense amounted to $1,632 and $2,504 for the three months ended December 31, 2015 and 2016, respectively, and $3,029 and $4,707 for the six months ended December 31, 2015 and 2016, respectively.

Intangible assets, net consist of the following:

	June 30, 2016	December 31, 2016	Weighted Average Useful Life
Client relationships	$ 12,580	$ 12,580	9 years
Non-solicitation agreements	360	360	2 - 3 years
Total	12,940	12,940	
Accumulated amortization	(2,521)	(3,283)	
Intangible assets, net	$ 10,419	$ 9,657	

Amortization expense for acquired intangible assets was $381 for both of the three months ended December 31, 2015 and 2016 and $761 and $762 for the six months ended December 31, 2015 and 2016, respectively.

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Future amortization expense for acquired intangible assets is as follows, as of December 31, 2016:

Remainder of fiscal 2017	$ 750
Fiscal 2018	1,427
Fiscal 2019	1,398
Fiscal 2020	1,398
Fiscal 2021	1,398
Thereafter	3,286
Total	$ 9,657

The components of accrued expenses were as follows:

	June 30, 2016	December 31, 2016
Accrued payroll and personnel costs	$ 21,658	$ 18,795
Current portion of deferred rent	504	243
Other	2,817	3,058
Total accrued expenses	$ 24,979	$ 22,096

(4) Fair Value Measurement

The Company applies the fair value measurement and disclosure provisions of ASC 820, Fair Value Measurements and Disclosures, and ASU 2011-04, Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRS. Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. A three-level fair value hierarchy prioritizes the inputs used to measure fair value. The hierarchy requires entities to maximize the use of observable inputs and minimize the use of unobservable inputs. The three levels of inputs used to measure fair value are as follows:

· Level 1—Quoted prices in active markets for identical assets and liabilities.

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Level 2—Quoted prices in active markets for similar assets and liabilities, or other inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.

· Level 3—Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets and liabilities. This includes certain pricing models, discounted cash flow methodologies and similar techniques that use significant unobservable inputs.

Substantially all of the Company's assets that are measured at fair value on a recurring basis are measured using Level 1 inputs. The Company considers the recorded value of its financial assets and liabilities, which consist primarily of cash and cash equivalents, accounts receivable, funds held for clients, accounts payable and client fund obligations to approximate the fair value of the respective assets and liabilities at June 30, 2016 and December 31, 2016 based upon the short-term nature of these assets and liabilities.

(5) Benefit Plans

(a) Equity Incentive Plan

The Company maintains a 2008 Equity Incentive Plan (the "2008 Plan") and a 2014 Equity Incentive Plan (the "2014 Plan") pursuant to which the Company has reserved shares of its common stock for issuance to its employees, directors and non-employee third parties. The 2014 Plan serves as the successor to the 2008 Plan and permits the granting of options to purchase common stock and other equity incentives at the discretion of the compensation committee of the Company's board of directors. No new awards have been or will be issued under the 2008 Plan since the effective date of the 2014 Plan. Outstanding awards under the 2008 Plan continue to be subject to the terms and conditions of the 2008 Plan. The number of shares of common stock reserved for issuance under the 2014 Plan will increase automatically each calendar year, continuing through and including January 1, 2024. The number of shares

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added each year will be equal to the lesser of (a) four and five tenths percent (4.5%) of the number of shares of common stock of the Company issued and outstanding on the immediately preceding December 31, or (b) an amount determined by the Company's board of directors.

As of December 31, 2016, the Company had 10,439 shares allocated to the plans, of which 4,763 shares were subject to outstanding options or awards. Generally, the Company issues previously unissued shares for the exercise of stock options or vesting of awards; however, shares previously subject to 2014 Plan grants or awards that are forfeited or net settled at exercise or release may be reissued to satisfy future issuances.

The following table summarizes changes in the number of shares available for grant under our equity incentive plans during the six months ended December 31, 2016:

	Number of Shares
Available for grant at July 1, 2016	6,244
RSUs granted	(746)
Shares withheld in settlement of taxes and/or exercise price	179
Forfeitures	37
Shares removed	(38)
Available for grant at December 31, 2016	5,676

Shares removed represents forfeitures of shares and shares withheld in settlement of taxes and/or payment of exercise price related to grants made under the 2008 Plan. As noted above, no new awards will be issued under the 2008 Plan.

Stock-based compensation expense related to stock options, restricted stock units ("RSUs"), and the Employee Stock Purchase Plan (as described below) is included in the following line items in the accompanying unaudited consolidated statements of operations:

	Three months ended December 31,		Six months ended December 31,	
	2015	2016	2015	2016
Cost of revenue – recurring	$ 448	$ 593	$ 805	$ 1,136
Cost of revenue – non-recurring	304	367	574	668
Sales and marketing	1,205	1,683	2,118	3,208
Research and development	815	870	1,384	1,664

General and administrative	2,008	3,122	3,611	5,772
Total stock-based compensation expense	$ 4,780	$ 6,635	$ 8,492	$ 12,448

In addition, the Company capitalized $276 and $500 of stock-based compensation expense in its capitalized internal-use software costs in the three months ended December 31, 2015 and 2016, respectively, and $542 and $872 in the six months ended December 31, 2015 and 2016, respectively.

Under the 2008 and 2014 Plans, the exercise price of each option cannot be less than the fair value of a share of common stock on the grant date. The options typically vest ratably over a three or four year period and expire 10 years from the grant date. Stock-based compensation expense for the fair value of the options at their grant date is recognized ratably over the vesting schedule for each separately vesting portion of the award.

The Company values stock options using the Black-Scholes option-pricing model, which requires the input of subjective assumptions, including the risk-free interest rate, expected life, expected stock price volatility and dividend yield. The risk-free interest rate assumption is based upon observed interest rates for U.S. Treasury securities consistent with the expected term of the Company's employee stock options. The expected life represents the period of time the stock options are expected to be outstanding and is based on the simplified method. Under the simplified method, the expected life of an option is presumed to be the mid-point between the vesting date and the end of the contractual term. As the Company has a limited history of trading as a public company, the Company utilizes the simplified method due to the lack of sufficient historical exercise data to provide a reasonable basis upon which to otherwise estimate the expected life of the stock options. Therefore, the expected volatility is based on historical volatilities for publicly traded stock of comparable companies over the estimated expected life of the stock options. The Company assumed no dividend yield

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because it does not expect to pay dividends in the near future, which is consistent with the Company’s history of not paying dividends.

There were no stock options granted during the six months ended December 31, 2016. The following table summarizes the assumptions used for estimating the fair value of stock options granted for the six months ended December 31, 2015:

	Period ended December 31, 2015	
Valuation assumptions:		
Expected dividend yield	0	%
Expected volatility	34.0	%
Expected term (years)	6.25	
Risk-free interest rate	1.83	%

The table below presents stock option activity during the six months ended December 31, 2016:

	Outstanding Options			
	Number of shares	Weighted average exercise price	Weighted average remaining contractual term (years)	Aggregate intrinsic value
Balance at July 1, 2016	3,464	$ 11.75	6.70	$ 108,944
Options forfeited	(11)	17.00		
Options exercised	(191)	13.81		
Balance at December 31, 2016	3,262	$ 11.61	6.17	$ 60,783
Options exercisable at December 31, 2016	2,354	$ 8.57	5.70	$ 50,648
Options vested and expected to vest at December 31, 2016	3,235	$ 11.50	6.16	$ 60,578

There were no stock options granted during the three months ended December 31, 2015 and 2016 or the six months ended December 31, 2016. The weighted average grant date fair value of options granted during the six months ended December 31, 2015 was $12.92. The total intrinsic value of options exercised was $4,653 and $1,648 during the three months ended December 31, 2015 and 2016, respectively, and $7,588 and $5,539 during the six months ended December 31, 2015 and 2016, respectively. At December 31, 2016, there was $1,552 of total unrecognized compensation cost, net of estimated forfeitures, related to unvested stock option granted under the Plan. That cost is expected to be recognized over a weighted average period of 1.33 years.

The Company may also grant RSUs under the 2014 Plan with terms determined at the discretion of the compensation committee of the Company's board of directors. RSUs generally vest over three or four years following the grant date. Certain RSU awards have time-based vesting conditions while other RSU awards are based on attainment of certain performance benchmarks. The following table represents restricted stock unit activity during the six months ended December 31, 2016:

	Units	Weighted average grant date fair value
RSU balance at July 1, 2016	1,003	$ 32.74
RSUs granted	746	$ 45.45
RSUs vested	(222)	$ 31.86
RSUs forfeited	(26)	$ 38.48
RSU balance at December 31, 2016	1,501	$ 39.06
RSUs expected to vest at December 31, 2016	1,318	$ 38.88

At December 31, 2016, there was $33,624 of total unrecognized compensation cost, net of estimated forfeitures, related to unvested restricted stock awards granted under the Plan. That cost is expected to be recognized over a weighted average period of 2.03 years.

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(b) Employee Stock Purchase Plan

Under the Company’s Employee Stock Purchase Plan (“ESPP”), the Company can grant stock purchase rights to all eligible employees during specific offering periods not to exceed twenty-seven months. Each offering period will begin on the trading day closest to May 16 and November 16 of each year. Shares are purchased through employees’ payroll deductions, up to a maximum of 10% of employees’ compensation for each purchase period, at a purchase price equal to 85% of the lesser of the fair market value of the Company’s common stock at the first trading day of the applicable offering period or the purchase date. Participants may purchase up to $25 worth of common stock or 2 shares of common stock in any one year. The ESPP is considered compensatory and results in compensation expense.

As of December 31, 2016, a total of 888 shares of common stock were reserved for future issuances under the ESPP. The number of shares of common stock reserved for issuance under the ESPP will increase automatically each calendar year, continuing through and including January 1, 2024. The number of shares added each year will be equal to the lesser of (a) 600, (b) seventy-five one hundredths percent (0.75%) of the number of shares of common stock of the Company issued and outstanding on the immediately preceding December 31, or (c) an amount determined by the Company’s board of directors.

The Company issued 64 shares upon the completion of its six-month offering period ending November 15, 2016. The Company recorded compensation expense attributable to the ESPP of $256 and $319 for the three months ended December 31, 2015 and 2016, respectively, and $508 and $663 for the six months ended December 31, 2015 and 2016, respectively, which is included in the summary of stock-based compensation expense above. The grant date fair value of the ESPP offering periods was estimated using the following weighted average assumptions:

	Period ended December 31,			
	2015		2016	
Valuation assumptions:				
Expected dividend yield	0	%	0	%
Expected volatility	44.1 - 48.4	%	38.9 - 53.4	%
Expected term (years)	0.5		0.5	
Risk free interest rate	0.11 - 0.31	%	0.28 - 0.61	%

(c) 401(k) Plan

The Company maintains a 401(k) plan with a matching provision that covers all eligible employees. Up to December 31, 2015, the Company matched 50% of the employees’ contributions up to 6% of their gross pay. Effective January 1, 2016, the Company increased its match to 50% of employees’ contributions up to 8% of their gross pay. Contributions were $536 and $775 for the three months ended December 31, 2015 and 2016, respectively, and were $1,116 and $1,677 for the six months ended December 31, 2015 and 2016, respectively.

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(6) Net Loss Per Share

Basic net loss per common share is computed using the weighted average number of common shares outstanding during the period. Diluted net loss per share is computed using the weighted average number of common shares outstanding during the period and, if dilutive, potential common shares outstanding during the period. The Company’s potential common shares consist of the incremental common shares issuable upon the exercise of stock options, the release of restricted stock units, and the shares purchasable via the employee stock purchase plan as of the balance sheet date. The following table presents the calculation of basic and diluted net loss per share:

	Three months ended December 31,		Six months ended December 31,	
	2015	2016	2015	2016
Numerator:				
Net loss	$ (1,165)	$ (1,671)	$ (4,600)	$ (4,239)
Denominator:				
Weighted-average shares used in computing net loss per share:				
Basic	50,890	51,384	50,817	51,308
Weighted-average effect of potentially dilutive shares:				
Employee stock options, restricted stock units and employee stock purchase plan shares	—	—	—	—
Diluted	50,890	51,384	50,817	51,308
Net loss per share:				
Basic	$ (0.02)	$ (0.03)	$ (0.09)	$ (0.08)
Diluted	$ (0.02)	$ (0.03)	$ (0.09)	$ (0.08)

The following table summarizes the outstanding employee stock options, restricted stock units, and shares purchasable via the employee stock purchase plan as of the balance sheet date that were excluded from the diluted per share calculation for the periods presented because to include them would have been anti-dilutive:

	Three months ended December 31,		Six months ended December 31,	
	2015	2016	2015	2016
Employee stock options	3,773	3,262	3,773	3,262
Restricted stock units	989	1,501	989	1,501
Employee stock purchase plan shares	13	21	13	21
Total	4,775	4,784	4,775	4,784

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(7) Income Taxes

The Company’s quarterly provision for income taxes is based on the discrete effective tax rate method. The Company’s quarterly provision for income taxes also includes the tax impact of certain unusual or infrequently occurring items, if any, including changes in judgment about valuation allowances and effects of changes in tax laws or rates, in the interim period in which they occur.

The Company recorded income tax expense of $85 and $32 for the three months ended December 31, 2015 and 2016 respectively, and $186 and $132 for the six months ended December 31, 2015 and 2016, respectively. The Company’s effective tax rates for the three and six months ended December 31, 2015 and 2016 differ from statutory rates primarily due to the existence of a valuation allowance recorded against the preponderance of the net deferred tax assets.

The Company reviews the likelihood that it will realize the benefit of its deferred tax assets and, therefore, the need for a valuation allowance on a quarterly basis. It established a valuation allowance on all of its net deferred tax assets except for deferred tax liabilities associated with indefinite-lived intangible assets during fiscal 2014, given that the Company determined that it was more likely than not that the Company would not recognize the benefits of its net operating loss carryforwards prior to their expiration. The Company has continued to carry the valuation allowance during fiscal 2016 and for the six months ended December 31, 2016. As of December 31, 2016, the Company had no unrecognized tax benefits.

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

The statements included herein that are not based solely on historical facts are “forward looking statements.” Such forward-looking statements are based on current expectations and assumptions that are subject to risks and uncertainties. Our actual results could differ materially from those anticipated by us in these forward-looking statements as a result of various factors, including those discussed below and under Part II, Item 1A: “Risk Factors.”

Overview

We are a cloud-based provider of payroll and human capital management (or “HCM”) software solutions for medium-sized organizations, which we define as those having between 20 and 1,000 employees. Our comprehensive and easy-to-use solutions enable our clients to manage their workforces more effectively. Our solutions help drive strategic human capital decision-making and improve employee engagement by enhancing the human resource, payroll and finance capabilities of our clients.

Effective management of human capital is a core function in all organizations and requires a significant commitment of resources. Medium-sized organizations operating without the infrastructure, expertise or personnel of larger enterprises are uniquely pressured to manage their human capital effectively.

Our solutions were specifically designed to meet the payroll and HCM needs of medium-sized organizations. We designed our cloud-based platform to provide a unified suite of applications using a multi-tenant architecture. Our solutions are highly flexible and configurable and feature a modern, intuitive user experience. Our platform offers automated data integration with over 200 related third-party systems, such as 401(k), benefits and insurance provider systems.

Our Paylocity Web Pay product is our core payroll solution and was the first of our current offerings introduced into the market. We believe payroll is the most critical system of record for medium-sized organizations and an essential gateway to other HCM functionality. We have invested in, and we intend to continue to invest in, research and development to expand our product offerings and advance our platform.

We believe there is a significant opportunity to grow our business by increasing our number of clients, and we intend to invest in our business to achieve this purpose. We market and sell our solutions primarily through our direct sales force. We have increased our sales and marketing expenses as we have added sales representatives and related sales and marketing personnel. We intend to continue to grow our sales and marketing organization across new and existing geographic territories. In addition to growing our number of clients, we intend to grow our revenue over the long term by increasing the number and quality of products that clients purchase from us. To do so, we must continue to enhance and grow the number of solutions we offer to advance our platform.

We believe that delivering a positive service experience is an essential element of our ability to sell our solutions and retain our clients. We seek to develop deep relationships with our clients through our unified service model, which has been designed to meet the service needs of medium-sized organizations. We expect to continue to invest in and grow our implementation and client service organization as our client base grows.

We believe we have the opportunity to continue to grow our business over the long term, and to do so, we have invested, and intend to continue to invest, across our entire organization. These investments include increasing the number of personnel across all functional areas, along with improving our solutions and infrastructure to support our growth. The timing and amount of these investments vary based on the rate at which we add new clients, add new personnel and scale our application development and other activities. Many of these investments will occur in advance of experiencing any direct benefit from them which will make it difficult to determine if we are effectively allocating our resources. We expect these investments to increase our costs on an absolute basis, but as we grow our number of clients and our related revenues, we anticipate that we will gain economies of scale and increased operating leverage. As a result, we expect our gross and operating margins will improve over the long term.

As our business has grown, we have become increasingly subject to the risks arising from adverse changes in domestic and global economic conditions. If general economic conditions were to deteriorate further, including declines in private sector employment growth and business productivity, increases in the unemployment rate and changes in interest rates, we may experience delays in our sales cycles, increased pressure from prospective customers to offer

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discounts and increased pressure from existing customers to renew expiring recurring revenue agreements for lower amounts. Our interest income on funds held for clients continues to be adversely impacted by historically low interest rates.

Our operating subsidiary Paylocity Corporation was incorporated in July 1997 as an Illinois corporation. In November 2013, we formed Paylocity Holding Corporation, a Delaware corporation, of which Paylocity Corporation is now a wholly-owned subsidiary. Paylocity Holding Corporation had no operations prior to the restructuring. All of our business operations, excluding interest earned on certain cash holdings and expenses associated with certain secondary stock offerings, have historically been, and are currently, conducted by Paylocity Corporation, and the financial results presented herein are entirely attributable to the results of its operations.

Key Metrics

We regularly review a number of metrics, including the following key metrics, to evaluate our business, measure our performance, identify trends affecting our business, formulate financial projections and make strategic decisions.

Recurring Revenue Growth

Our recurring revenue model and high annual revenue retention rates provide significant visibility into our future operating results and cash flow from operations. This visibility enables us to better manage and invest in our business. Recurring revenue, which is comprised of recurring fees and interest income on funds held for clients, increased from $52.3 million for the three months ended December 31, 2015 to $66.1 million for the three months ended December 31, 2016, representing a 26% year-over-year increase. Recurring revenue increased from $95.2 million for the six months ended December 31, 2015 to $128.7 million for the six months ended December 31, 2016, representing a 35% year-over-year increase. Recurring revenue represented 95% and 96% of total revenue during both the three months and six months ended December 31, 2015 and 2016, respectively. Recurring revenue was positively impacted by the launch in fiscal 2016 of our Affordable Care Act (“ACA”) compliance solution, which had significant penetration beginning in the second quarter of fiscal 2016. We expect the impact on year-over-year quarterly revenue growth of our ACA compliance solution to be highest in the first quarter of fiscal 2017 given the timing of significant penetration beginning in the second quarter of fiscal 2016.

Recurring Fees from New Clients

We calculate recurring fees from new clients as the percentage of year-to-date recurring fees from all clients on our solutions which had not been on or used any of our solutions for a full year as of the start of the current fiscal year.

We believe recurring fees from new clients is an important metric to measure the expansion of our existing client base as well as the growth in our client base. Our recurring fees from new clients was 42% and 36% for the three months ended December 31, 2015 and 2016, respectively, and 39% and 34% for the six months ended December 31, 2015 and 2016, respectively.

Adjusted Gross Profit, Adjusted Recurring Gross Profit and Adjusted EBITDA

We disclose Adjusted Gross Profit, Adjusted Recurring Gross Profit and Adjusted EBITDA because we use them to evaluate our performance, and we believe Adjusted Gross Profit, Adjusted Recurring Gross Profit and Adjusted EBITDA assist in the comparison of our performance across reporting periods by excluding certain items that we do not believe are indicative of our core operating performance. We believe these metrics are used in the financial community, and we present it to enhance investors' understanding of our operating performance and cash flows.

Adjusted Gross Profit, Adjusted Recurring Gross Profit and Adjusted EBITDA are not measurements of financial performance under generally accepted accounting principles in the United States, or GAAP, and you should not consider Adjusted Gross Profit as an alternative to gross profit, Adjusted Recurring Gross Profit as an alternative to total recurring revenues, or Adjusted EBITDA as an alternative to net income (loss) or cash provided by (used in) operating activities, in each case as determined in accordance with GAAP. In addition, our definition of Adjusted Gross Profit, Adjusted Recurring Gross Profit and Adjusted EBITDA may be different than the definition utilized for similarly-titled measures used by other companies.

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We define Adjusted Gross Profit as gross profit before amortization of capitalized internal-use software costs, stock-based compensation expense, and employer payroll taxes related to stock releases and option exercises. We define Adjusted Recurring Gross Profit as total recurring revenues after cost of recurring revenues and before amortization of capitalized internal-use software costs, stock-based compensation expense, and employer payroll taxes related to stock releases and option exercises. We define Adjusted EBITDA as net income (loss) before interest expense, income tax expense, depreciation and amortization, stock-based compensation expense, and employer payroll taxes related to stock releases and option exercises. The table below sets forth our Adjusted Gross Profit, Adjusted Recurring Gross Profit and Adjusted EBITDA for the periods presented.

	Three months ended December 31,		Six months ended December 31,	
	2015	2016	2015	2016
	(in thousands)		(in thousands)	
Adjusted Gross Profit	$ 33,279	$ 41,194	$ 59,822	$ 80,494
Adjusted Recurring Gross Profit	$ 38,106	$ 47,912	$ 69,179	$ 93,735
Adjusted EBITDA	$ 7,236	$ 9,870	$ 10,527	$ 17,841

	Three months ended December 31,		Six months ended December 31,	
	2015	2016	2015	2016
	(in thousands)		(in thousands)	
Reconciliation from Gross Profit to Adjusted Gross Profit				
Gross profit	$ 31,084	$ 38,271	$ 55,997	$ 74,934
Amortization of capitalized internal-use software costs	1,423	1,950	2,365	3,634
Stock-based compensation expense and employer payroll taxes related to stock releases and option exercises	772	973	1,460	1,926
Adjusted Gross Profit	$ 33,279	$ 41,194	$ 59,822	$ 80,494

	Three months ended December 31,		Six months ended December 31,	
	2015	2016	2015	2016
	(in thousands)		(in thousands)	
Reconciliation from Total Recurring Revenues to Adjusted Recurring Gross Profit				
Total recurring revenues	$ 52,347	$ 66,078	$ 95,238	$ 128,715
Cost of recurring revenues	16,125	20,716	29,282	39,819
Recurring gross profit	36,222	45,362	65,956	88,896
Amortization of capitalized internal-use software costs	1,423	1,950	2,365	3,634
Stock-based compensation expense and employer payroll taxes related to stock releases and option exercises	461	600	858	1,205
Adjusted Recurring Gross Profit	$ 38,106	$ 47,912	$ 69,179	$ 93,735

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	Three months ended December 31,		Six months ended December 31,	
	2015	2016	2015	2016
	(in thousands)		(in thousands)	
Reconciliation from Net Loss to Adjusted EBITDA				
Net loss	$ (1,165)	$ (1,671)	$ (4,600)	$ (4,239)
Income tax expense	85	32	186	132
Depreciation and amortization expense	3,436	4,835	6,155	9,103
EBITDA	2,356	3,196	1,741	4,996
Stock-based compensation expense and employer payroll taxes related to stock releases and option exercises	4,880	6,674	8,786	12,845
Adjusted EBITDA	$ 7,236	$ 9,870	$ 10,527	$ 17,841

Basis of Presentation

Revenues

Recurring Fees

We derive the majority of our revenues from recurring fees attributable to our cloud-based payroll and HCM software solutions. Recurring fees for each client generally include a base fee in addition to a fee based on the number of client employees and the number of products a client uses. We also charge fees attributable to our preparation of W-2 documents and annual required filings on behalf of our clients. Over the past three years, our client size has been on average over 100 employees. We derive revenue from a client based on the solutions purchased by the client, the number of client employees as well as the amount, type and timing of services provided with respect to those client employees. As such, the number of client employees on our system is not a good indicator of our financial results in any period. Recurring fees attributable to our cloud-based payroll and HCM solutions accounted for 94% and 95% of our total revenues during both the three and six months ended December 31, 2015 and 2016, respectively.

Our agreements with clients do not have a specified term and are generally cancellable by the client on 60 days' or less notice. Our agreements do not include general rights of return and do not provide clients with the right to take possession of the software supporting the services being provided. We recognize recurring fees in the period in which services are provided and when collection of fees is reasonably assured and the amount of fees is fixed or determinable.

Interest Income on Funds Held for Clients

We earn interest income on funds held for clients. We collect funds for employee payroll payments and related taxes in advance of remittance to employees and taxing authorities. Prior to remittance to employees and taxing authorities, we earn interest on these funds through financial institutions with which we have automated clearing house, or ACH, arrangements.

Implementation Services and Other

Implementation services and other revenues primarily consist of implementation fees charged to new clients for professional services provided to implement and configure our payroll and HCM solutions. Implementations of our payroll solutions typically require only three to four weeks at which point the new client's payroll is first run using our solution, our implementation services are deemed completed, and we recognize the related revenue. We implement additional HCM products as requested by clients and leverage the data within our payroll solution to accelerate our implementation processes. Implementation services and other revenues may fluctuate significantly from quarter to quarter based on the number of new clients, pricing and the product utilization.

Cost of Revenues

Cost of Recurring Revenues

Cost of recurring revenues is generally expensed as incurred, and includes costs to provide our payroll and other HCM solutions primarily consisting of employee-related expenses, including wages, stock-based compensation,

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bonuses and benefits, relating to the provision of ongoing client support, payroll tax filing and distribution of printed checks and other materials. These costs also include amortization of capitalized internal-use software costs, delivery costs and computing costs, as well as bank fees associated with client fund transfers. We expect to realize cost efficiencies over the long term as our business scales, resulting in improved operating leverage and increased margins.

We capitalize a portion of our internal-use software costs, which are then all amortized as a cost of recurring revenues. We amortized $1.4 million and $2.0 million of capitalized internal-use software costs during the three months ended December 31, 2015 and 2016, respectively, and $2.4 million and $3.6 million of capitalized internal-use software costs during the six months ended December 31, 2015 and 2016, respectively.

Cost of Implementation Services and Other

Cost of implementation services and other consists primarily of employee-related expenses, including wages, stock-based compensation, bonuses and benefits involved in the implementation of our payroll and other HCM solutions for new clients. Implementation costs are generally fixed in the short-term and exceed associated implementation revenue charged to each client. We intend to grow our business through acquisition of new clients, and doing so will require increased personnel to implement our solutions. Therefore our cost of implementation services and other is expected to increase in absolute dollars for the foreseeable future.

Operating Expenses

Sales and Marketing

Sales and marketing expenses consist primarily of employee-related expenses for our direct sales and marketing staff, including wages, commissions, stock-based compensation, bonuses and benefits, marketing expenses and other related costs. Commissions are primarily earned and recognized in the month when implementation is complete and the client first utilizes a service, typically by running its first payroll. Bonuses paid to sales staff for attainment of certain performance criteria are accrued in the fiscal year in which they are earned and are subsequently paid annually in the first fiscal quarter of the following year.

We will seek to grow our number of clients for the foreseeable future and therefore our sales and marketing expense is expected to continue to increase in absolute dollars as we grow our sales organization and expand our marketing activities.

Research and Development

Research and development expenses consist primarily of employee-related expenses for our research and development and product management staff, including wages, stock-based compensation, bonuses and benefits. Additional expenses include costs related to the development, maintenance, quality assurance and testing of new technologies and ongoing refinement of our existing solutions. Research and development expenses, other than internal-use software costs qualifying for capitalization, are expensed as incurred.

We capitalize a portion of our development costs related to internal-use software. The timing of our capitalized development projects may affect the amount of development costs expensed in any given period. The table below sets forth the amounts of capitalized and expensed research and development expenses for the three and six months ended December 31, 2015 and 2016.

	Three months ended December 31,		Six months ended December 31,	
	2015	2016	2015	2016
Capitalized portion of research and development	$ 2,008	$ 3,842	$ 4,317	$ 7,151
Expensed portion of research and development	6,799	7,222	12,228	14,523
Total research and development	$ 8,807	$ 11,064	$ 16,545	$ 21,674

We expect to grow our research and development efforts as we continue to broaden our product offerings and extend our technological leadership by investing in the development of new technologies and introducing them to new and existing clients. We expect research and development expenses to continue to increase in absolute dollars but to vary as a percentage of total revenue on a period-to-period basis.

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General and Administrative

General and administrative expenses consist primarily of employee-related costs, including wages, stock-based compensation, bonuses and benefits for our administrative, finance, accounting, and human resources departments. Additional expenses include consulting and professional fees, occupancy costs, insurance and other corporate expenses.

We expect our general and administrative expenses to continue to increase in absolute dollars as a result of our operations as a public company. These expenses include costs associated with compliance with regulations governing public companies, costs of directors' and officers' liability insurance and professional services expenses.

Other Income

Other income generally consists of interest income related to interest received on our cash and cash equivalents, net of losses on disposal of property and equipment.

Results of Operations

The following table sets forth our statements of operations data for each of the periods indicated.

	Three months ended December 31,		Six months ended December 31,	
	2015	2016	2015	2016
	(in thousands)		(in thousands)	
Consolidated Statements of Operations Data:				
Revenues:				
Recurring fees	$ 51,732	$ 65,347	$ 94,095	$ 127,267
Interest income on funds held for clients	615	731	1,143	1,448
Total recurring revenues	52,347	66,078	95,238	128,715
Implementation services and other	2,837	2,576	5,054	4,961
Total revenues				