BLACKBAUD INC
Form 10-Q
August 11, 2008

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended June 30, 2008

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	**11-2617163**
(State or other jurisdiction of	**(I.R.S. Employer**
incorporation or organization)	**Identification No.)**

2000 Daniel Island Drive

Charleston, South Carolina 29492

(Address of principal executive offices, including zip code)

(843) 216-6200

(Registrant s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES x NO ¨

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

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

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

The number of shares of the registrant s Common Stock outstanding as of August 1, 2008 was 43,572,381.

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BLACKBAUD, INC.

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PART I - FINANCIAL INFORMATION

Item 1. Financial statements

Blackbaud, Inc.

Consolidated balance sheets

(Unaudited)

(in thousands, except share amounts)	June 30, 2008	December 31, 2007
Assets		
Current assets:		
Cash and cash equivalents	$ 9,979	$ 14,775
Accounts receivable, net of allowance of $1,728 and $1,935 at June 30, 2008 and December 31, 2007, respectively	64,227	44,689
Prepaid expenses and other current assets	10,287	11,279
Deferred tax asset, current portion	2,802	2,276
Total current assets	87,295	73,019
Property and equipment, net	16,967	16,962
Deferred tax asset	48,795	51,696
Goodwill	61,175	58,275
Intangible assets, net	35,133	37,272
Other assets	490	470
Total assets	$ 249,855	$ 237,694
Liabilities and stockholders equity		
Current liabilities:		
Trade accounts payable	$ 6,341	$ 5,802
Accrued expenses and other current liabilities	18,180	20,575
Capital lease obligations, current portion	470	513
Short-term debt	24,500	-
Deferred revenue	107,000	93,106
Total current liabilities	156,491	119,996
Capital lease obligations, noncurrent	352	586
Deferred revenue, noncurrent	3,093	2,994
Other noncurrent liabilities	613	1,015
Total liabilities	160,549	124,591
Commitments and contingencies (Note 9)		
Stockholders equity:		
Preferred stock; 20,000,000 shares authorized, none outstanding	-	-
Common stock, $0.001 par value; 180,000,000 shares authorized, 50,499,324 and 50,450,675 shares issued at June 30, 2008 and December 31, 2007, respectively	50	50

Additional paid-in capital	110,771	105,687
Treasury stock, at cost; 6,933,667 and 5,431,852 shares at June 30, 2008 and December 31, 2007, respectively	(121,514)	(85,487)
Accumulated other comprehensive income	91	137
Retained earnings	99,908	92,716
Total stockholders equity	89,306	113,103
Total liabilities and stockholders equity	$ 249,855	$ 237,694

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

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Blackbaud, Inc.

Consolidated statements of operations

(Unaudited)

	Three months ended June 30,		Six months ended June 30,	
(in thousands, except share and per share amounts)	**2008**	**2007**	**2008**	**2007**
Revenue				
License fees	$ 9,603	$ 11,030	$ 19,238	$ 19,097
Services	25,336	22,218	48,912	40,532
Maintenance	26,371	23,164	51,801	45,600
Subscriptions	9,010	5,539	17,795	10,332
Other revenue	2,182	2,094	4,192	3,629
Total revenue	72,502	64,045	141,938	119,190
Cost of revenue				
Cost of license fees	807	804	1,649	1,280
Cost of services	14,905	13,606	30,598	25,722
Cost of maintenance	4,595	4,220	9,299	8,239
Cost of subscriptions	3,824	2,190	7,480	4,114
Cost of other revenue	2,023	1,776	3,871	3,136
Total cost of revenue	26,154	22,596	52,897	42,491
Gross profit	46,348	41,449	89,041	76,699
Operating expenses				
Sales and marketing	15,672	14,223	30,911	27,140
Research and development	8,642	6,926	17,409	13,753
General and administrative	7,273	6,592	14,539	12,736
Amortization	167	98	334	182
Total operating expenses	31,754	27,839	63,193	53,811
Income from operations	14,594	13,610	25,848	22,888
Interest income	34	156	199	527
Interest expense	(148)	(379)	(218)	(746)
Other income (expense), net	49	(8)	(40)	(77)
Income before provision for income taxes	14,529	13,379	25,789	22,592
Income tax provision	5,542	5,176	9,759	8,633
Net income	$ 8,987	$ 8,203	$ 16,030	$ 13,959
Earnings per share				
Basic	$ 0.21	$ 0.19	$ 0.37	$ 0.32

Diluted	$ 0.21	$ 0.19	$ 0.36	$ 0.31
Common shares and equivalents outstanding				
Basic weighted average shares	42,776,609	43,355,261	43,336,989	43,508,166
Diluted weighted average shares	43,457,710	44,338,741	44,064,436	44,501,949
Dividends per share	$ 0.100	$ 0.085	$ 0.200	$ 0.170

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

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Blackbaud, Inc.

Consolidated statements of cash flows

(Unaudited)

(in thousands)	Six months ended June 30, 2008	2007
Cash flows from operating activities		
Net income	$ 16,030	$ 13,959
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	5,107	3,570
Provision for doubtful accounts and sales returns	2,199	1,271
Stock-based compensation expense	4,678	3,511
Excess tax benefit on exercise of stock options	(18)	(709)
Deferred taxes	2,363	4,028
Other non-cash adjustments	37	24
Changes in assets and liabilities, net of acquisition:		
Accounts receivable	(20,886)	(11,897)
Prepaid expenses and other assets	994	1,250
Trade accounts payable	519	(1,388)
Accrued expenses and other current liabilities	(2,773)	(3,589)
Deferred revenue	13,218	9,360
Net cash provided by operating activities	21,468	19,390
Cash flows from investing activities		
Purchase of property and equipment	(2,957)	(3,128)
Purchase of net assets of acquired companies	(2,895)	(59,243)
Net cash used in investing activities	(5,852)	(62,371)
Cash flows from financing activities		
Proceeds from issuance of debt	27,200	30,000
Proceeds from exercise of stock options	393	828
Excess tax benefit on exercise of stock options	18	709
Payments on debt	(2,708)	(16,922)
Payments of deferred financing fees	(47)	-
Payments on capital lease obligations	(276)	(204)
Purchase of treasury stock	(36,027)	(14,106)
Dividend payments to stockholders	(8,843)	(7,503)
Net cash used in financing activities	(20,290)	(7,198)
Effect of exchange rate on cash and cash equivalents	(122)	59
Net decrease in cash and cash equivalents	(4,796)	(50,120)
Cash and cash equivalents, beginning of period	14,775	67,783
Cash and cash equivalents, end of period	$ 9,979	$ 17,663

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

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Blackbaud, Inc.

Consolidated statements of stockholders equity and comprehensive income

(Unaudited)

(in thousands, except share amounts)	Comprehensive income	Common stock Shares	Common stock Amount	Additional paid-in capital	Treasury stock	Accumulated other comprehensive income	Retained earnings	Total stockholders equity
Balance at December 31, 2006		49,205,522	$ 49	$ 88,409	$ (69,630)	$ 232	$ 76,298	$ 95,358
Net income	$ 31,724	-	-	-	-	-	31,724	31,724
Payment of dividends	-	-	-	-	-	-	(15,074)	(15,074)
Purchase of 633,878 treasury shares under stock repurchase program and surrender of 54,079 shares upon restricted stock vesting	-	-	-	-	(15,857)	-	-	(15,857)
Exercise of stock options	-	776,125	1	5,450	-	-	-	5,451
Tax impact of exercise of nonqualified stock options	-	-	-	4,931	-	-	-	4,931
Cumulative effect of FIN 48 adoption	-	-	-	-	-	-	(269)	(269)
Stock-based compensation	-	-	-	6,897	-	-	37	6,934
Restricted stock grants	-	549,320	-	-	-	-	-	-
Restricted stock cancellations	-	(80,292)	-	-	-	-	-	-
Translation adjustment, net of tax	(95)	-	-	-	-	(95)	-	(95)
Comprehensive income	$ 31,629							
Balance at December 31, 2007		50,450,675	$ 50	$ 105,687	$ (85,487)	$ 137	$ 92,716	$ 113,103
Net income	$ 16,030	-	-	-	-	-	16,030	16,030
Payment of dividends	-	-	-	-	-	-	(8,843)	(8,843)
Purchase of 1,499,745 treasury shares under stock repurchase program and surrender of 2,070 shares upon restricted stock vesting	-	-	-	-	(36,027)	-	-	(36,027)
Exercise of stock options	-	63,286	-	393	-	-	-	393
Tax impact of exercise of nonqualified stock options	-	-	-	18	-	-	-	18
Stock-based compensation	-		-	4,673	-	-	5	4,678
Restricted stock grants	-	7,928	-	-	-	-	-	-
Restricted stock cancellations	-	(22,565)	-	-	-	-	-	-
Translation adjustment, net of tax	(46)	-	-	-	-	(46)	-	(46)
Comprehensive income	$ 15,984							
Balance at June 30, 2008		50,499,324	$ 50	$ 110,771	$ (121,514)	$ 91	$ 99,908	$ 89,306

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

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Blackbaud, Inc.

Condensed notes to consolidated financial statements

(Unaudited)

1. Organization

Blackbaud, Inc. (the Company) is the leading global provider of software and related services designed specifically for nonprofit organizations, and provides products and services that enable nonprofit organizations to increase donations, reduce fundraising costs, improve communications with constituents, manage finances and optimize internal operations. As of June 30, 2008, the Company had approximately 19,000 active customers distributed across multiple verticals within the nonprofit market including education, foundations, health and human services, religion, arts and cultural, public and societal benefits, environment and animal welfare and international foreign affairs.

2. Summary of significant accounting policies

Unaudited interim financial statements

The interim consolidated financial statements as of June 30, 2008, and for the three and six months ended June 30, 2008 and 2007, have been prepared by the Company pursuant to the rules and regulations of the 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 operations, consolidated statements of cash flows and consolidated statements of stockholders equity and comprehensive income for the periods presented in accordance with accounting principles generally accepted in the United States (U.S. GAAP). The consolidated balance sheet at December 31, 2007 has been derived from the audited consolidated financial statements at that date. Operating results for the three and six months ended June 30, 2008 are not necessarily indicative of the results that may be expected for the fiscal year ending December 31, 2008 or any other future period. Certain information and footnote disclosures normally included in annual financial statements prepared in accordance with U.S. 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 the Company s Annual Report on Form 10-K for the year ended December 31, 2007 and other forms filed with the SEC from time to time.

Basis of consolidation

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

Reclassifications

Certain amounts in the 2007 statement of cash flows have been reclassified to conform to the 2008 presentation. Under the current presentation, the excess tax benefit on the exercise of stock options is shown as a separate adjustment to reconcile net income to net cash provided by operating activities; in prior periods the change was included in accrued expenses and other current liabilities in 2007.

Use of estimates

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions. These estimates and assumptions affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, as well as the reported amounts of revenues and expenses during the reporting periods. Areas of the financial statements where estimates may have the most significant effect include revenue recognition, the allowance for sales returns and doubtful accounts, valuation of long-lived and intangible assets and goodwill, stock-based compensation and provision for income taxes and valuation of deferred tax assets. Changes in the facts or circumstances underlying these estimates could result in material changes and actual results could differ from these estimates.

Revenue recognition

The Company s revenue is generated primarily by selling perpetual licenses or charging for the use of its software products and providing support, training, consulting, technical and other professional services for those products. The Company makes available certain of its software products for use in hosted application arrangements without licensing perpetual rights to the software (hosted applications). Additionally, the Company provides hosting services to customers

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Blackbaud, Inc.

Condensed notes to consolidated financial statements (continued)

(Unaudited)

who have purchased perpetual rights to certain of its software products (hosting services). The Company recognizes revenue in accordance with:

The American Institute of Certified Public Accountants Statements of Position (SOP) 97-2, Software Revenue Recognition, as modified by SOPs 98-4 and 98-9, as well as Technical Practice Aids issued from time to time by the American Institute of Certified Public Accountants;

The SEC Staff Accounting Bulletin (SAB) No. 104, Revenue Recognition in Financial Statements;

The Emerging Issues Task Force (EITF) Issue No. 00-03, Application of AICPA Statement of Position 97-2 to Arrangements that Include the Right to Use Software Stored on Another Entity s Hardware;

The EITF Issue No. 00-21, Revenue Arrangements with Multiple Deliverables; and

The SOP 81-1, Accounting for Performance of Construction-Type and Certain Production-Type Contracts.

The Company recognizes revenue from the sale of perpetual software license rights when persuasive evidence of an arrangement exists, the product has been delivered, title and risk of loss have transferred to the customers, the fee is fixed or determinable and collection of the resulting receivable is probable. The Company deems acceptance of an agreement to be evidence of an arrangement. Delivery occurs when the product is shipped or transmitted. The Company s typical license agreement does not include customer acceptance provisions; if acceptance provisions are provided, delivery is deemed to occur upon acceptance. The Company considers the fee to be fixed or determinable unless the fee is subject to refund or adjustment or is not payable within the Company s standard payment terms. The Company considers payment terms greater than 90 days to be beyond its customary payment terms. The Company deems collection probable if the Company expects that the customer will be able to pay amounts under the arrangement as they become due. If the Company determines that collection is not probable, the Company postpones recognition of the revenue until collection. The Company sells software licenses with maintenance and, often times, professional services. The Company allocates revenue to delivered components, normally the license component of the arrangement, using the residual value method based on objective evidence of the fair value of the undelivered elements, which is specific to the Company. Fair value for the maintenance services associated with the Company s software licenses is based upon renewal rates stated in the Company s agreements, which vary according to the level of the maintenance program. Fair value of professional services and other products and services is based on sales of these products and services to other customers when sold on a stand-alone basis.

The Company s consulting, installation and implementation services are generally billed based on hourly rates plus reimbursable travel-related expenses. For small service engagements, less than approximately $10,000, the Company frequently contracts for and bills based on a fixed fee plus reimbursable travel-related expenses. The Company recognizes this revenue upon completion of the work performed. When the Company s services include software customization, these services are provided to support customer requests for assistance in creating special reports and other minor enhancements that will assist with efforts to improve operational efficiency and/or to support business process improvements. These services are not essential to the functionality of the Company s software and rarely exceed three months in duration. The Company recognizes revenue as these services are performed. When the Company enters into larger fixed price contracts, the Company recognizes revenue on a percent-complete basis.

The Company recognizes analytic services revenue from donor prospect research engagements, the sale of lists of potential donors, benchmarking studies and data modeling service engagements upon delivery.

The Company sells training at a fixed rate for each specific class, at a per attendee price, or at a packaged price for several attendees, and revenue is recognized only upon the customer attending and completing training. Additionally, the Company sells a fixed-rate program, which permits customers to attend unlimited training over a specified contract period, typically one year, subject to certain restrictions, and revenue is recognized ratably over this contract period.

The Company recognizes revenue from maintenance services ratably over the contract term, which is principally one year. Maintenance contracts also include the right to unspecified product upgrades on an if-and-when available basis. Certain support services are sold in prepaid units of time and recognized as revenue upon their usage.

Subscription revenue includes revenue associated with hosted applications, hosting services, data enrichment services, data management services and online training programs. Subscription-based revenue and any related set-up fees are recognized ratably over the service period of the contract.

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Blackbaud, Inc.

Condensed notes to consolidated financial statements (continued)

(Unaudited)

To the extent that the Company s customers are billed and/or pay for the above described services in advance of delivery, the amounts are recorded in deferred revenue.

Stock-based compensation

Stock-based compensation is accounted for in accordance with the provisions of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards (SFAS) No. 123 (revised 2004), Share-Based Payment (SFAS No. 123(R)). Under the fair value recognition provisions of this statement, stock-based compensation cost is measured at the grant date based on the fair value of the award and is recognized as expense over the requisite service period, which is the vesting period. The provisions of SFAS No. 123(R) apply to grants made after the adoption date, awards modified, repurchased or cancelled after the adoption date and existing grants that were partially unvested at that date. Compensation expense for grants outstanding on the date of adoption is recognized over the remaining service period using the grant date fair values and amortization methods determined previously for the SFAS No. 123, Accounting for Stock-Based Compensation, pro forma disclosures.

The Company did not grant any new stock options in the six months ended June 30, 2008. During the six months ended June 30, 2008, the Company granted 7,928 shares of restricted stock and 99,690 stock appreciation rights. The aggregate grant date fair value of awards issued during the period was $1,049,000, which will be recognized as expense over the requisite service period of the awards.

The Company allocates stock-based compensation to expense categories on the statements of operations. The following table summarizes stock-based compensation expense for the three and six months ended June 30, 2008 and 2007.

	Three months ended June 30,		Six months ended June 30,	
(in thousands)	**2008**	**2007**	**2008**	**2007**
Included in cost of revenue:				
Cost of services	$ 302	$ 182	$ 652	$ 339
Cost of maintenance	119	52	231	99
Cost of subscriptions	58	11	85	21
Total included in cost of revenue	479	245	968	459
Included in operating expenses:				
Sales and marketing	295	261	581	521
Research and development	508	266	1,028	535
General and administrative	1,037	1,027	2,101	1,996
Total included in operating expenses	1,840	1,554	3,710	3,052
Total	$ 2,319	$ 1,799	$ 4,678	$ 3,511

The Company, upon the approval of its stockholders in June 2008, adopted the Blackbaud, Inc. 2008 Equity Incentive Plan. There are 7,126,520 shares reserved for issuance under the 2008 Equity Incentive Plan and all other stock plans of the Company, including the 2004 Stock Plan, 2001 Stock Option Plan and 1999 Stock Option Plan, are terminated as to future grants. Employees, directors and consultants are eligible to receive stock awards under the 2008 Equity Incentive Plan. The Company may grant incentive stock options, nonstatutory stock options, restricted stock awards, restricted stock unit awards, stock appreciation rights, performance stock awards and other stock awards under this plan.

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Blackbaud, Inc.

Condensed notes to consolidated financial statements (continued)

(Unaudited)

Amortization expense

Amortization expense related to intangible assets acquired in business combinations is allocated to cost of revenue on the statements of operations based on the revenue stream to which the asset contributes. The following table summarizes amortization expense for the three and six months ended June 30, 2008 and 2007.

	Three months ended June 30,		Six months ended June 30,	
(in thousands)	**2008**	**2007**	**2008**	**2007**
Included in cost of revenue:				
Cost of license fees	$ 43	$ 43	$ 86	$ 67
Cost of services	334	312	668	533
Cost of maintenance	98	103	196	181
Cost of subscriptions	409	214	818	403
Cost of other revenue	19	21	38	37
Total included in cost of revenue	903	693	1,806	1,221
Included in operating expenses	167	98	334	182
Total	$ 1,070	$ 791	$ 2,140	$ 1,403

Income taxes

Prior to October 13, 1999, the Company was organized as an S corporation under the Internal Revenue Code and, therefore, was not subject to federal income taxes. The Company historically made distributions to its stockholders to cover the stockholders anticipated tax liability. In connection with its 1999 recapitalization, the Company converted its U.S. taxable status from an S corporation to a C corporation and, accordingly, since October 14, 1999 has been subject to federal and state income taxes. Upon this conversion and as a result of the recapitalization, the Company recorded a one-time benefit of $107,000,000 to establish a deferred tax asset. This amount was recorded as a direct increase to equity in the statements of stockholders equity. The Company did not record a valuation allowance against this item in its deferred tax asset as of June 30, 2008 or December 31, 2007, as the Company believed at those dates it was more likely than not that it would be able to utilize this benefit, which is dependent upon the Company s ability to generate future taxable income.

The Company adopted FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109, Accounting for Income Taxes, (FIN 48) on January 1, 2007. Under FIN 48 the tax benefit from an uncertain tax position must be recognized only if it is more likely than not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the financial statements from such a position are measured based on the largest benefit that has a greater than 50% likelihood of being realized upon ultimate resolution. Penalties and interest accrued related to unrecognized tax benefits are recognized in the provision for income taxes.

Significant judgment is required in determining the provision for income taxes. The Company records its tax provision at the anticipated tax rates based on estimates of annual pretax income. To the extent that the final results differ from these estimated amounts that were initially recorded, the differences impact the income tax provision in the period in which the determination is made and could have an impact on the deferred tax asset. The Company s deferred tax assets and liabilities are recorded at an amount based upon a U.S. federal income tax rate of 35.0% and appropriate statutory rates of various foreign, state and local jurisdictions in which the Company operates. If the Company s tax rates change, the deferred tax assets and liabilities may be adjusted to an amount reflecting those income tax rates. If such change is determined to be appropriate, it will affect the provision for income taxes during the period that the determination is made.

New accounting pronouncements

In June 2008, the FASB issued FASB Staff Position (FSP) No. EITF 03-6-1, Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities (FSP EITF 03-6-1), which clarifies that share-based payment awards that entitle their holders to receive nonforfeitable dividends before vesting should be considered participating securities. As participating securities, these instruments should be included in the calculation of basic earnings per share using the two-class method. Under FSP EITF 03-6-1, restricted stock issued by the Company is considered to be participating and would need to be included in the calculation of basic earnings per share at adoption. The

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Blackbaud, Inc.

Condensed notes to consolidated financial statements (continued)

(Unaudited)

Company is currently evaluating the impact that FSP EITF 03-6-1 will have on its financial statements. FSP EITF 03-6-1 will be effective for the Company on January 1, 2009.

In May 2008, the FASB issued SFAS No. 162, The Hierarchy of Generally Accepted Accounting Principles (SFAS No. 162). This standard is intended to improve financial reporting by identifying a consistent framework, or hierarchy, for selecting accounting principles to be used in preparing financial statements that are presented in conformity with generally accepted accounting principles in the United States for non-governmental entities. SFAS No. 162 will be effective 60 days following approval by the U.S. Securities and Exchange Commission of the Public Company Accounting Oversight Board s amendments to AU Section 411, The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles. The Company does not expect SFAS No. 162 to have a material impact on the preparation of its consolidated financial statements.

In April 2008, the FASB issued FSP FAS 142-3, Determination of the Useful Life of Intangible Assets (FSP FAS 142-3). FSP FAS 142-3 removes the requirement of SFAS No. 142, Goodwill and Other Intangible Assets (SFAS No. 142) for an entity to consider, when determining the useful life of an acquired intangible asset, whether the intangible asset can be renewed without substantial cost or material modifications to the existing terms and conditions associated with the intangible asset. FSP FAS 142-3 replaces the previous useful-life assessment criteria with a requirement that an entity consider its own experience in renewing similar arrangements. If the entity has no relevant experience, it would consider market participant assumptions regarding renewal. FSP FAS 142-3 will be effective for the Company on January 1, 2009. The Company is currently evaluating the potential impact of adopting FSP FAS 142-3.

In March 2008, the FASB issued SFAS No. 161, Disclosures about Derivative Instruments and Hedging Activities-an amendment of FASB Statement No. 133 (SFAS No. 161). SFAS No. 161 is intended to improve financial standards for derivative instruments and hedging activities by requiring enhanced disclosures to enable investors to better understand their effects on an entity's financial position, financial performance, and cash flows. SFAS No. 161 requires enhanced disclosures of: (a) how and why an entity uses derivative instruments; (b) how derivative instruments and related hedged items are accounted for under FAS No. 133, Accounting for Derivative Instruments and Hedging Activities (FAS No. 133); and (c) its related interpretations and how derivative instruments and related hedged items affect an entity s financial position, financial performance and cash flows. SFAS No. 161 must be applied prospectively to all derivative instruments and non-derivative instruments that are designated and qualify as hedging instruments and related hedged items accounted for under FAS No. 133 for all financial statements issued for fiscal years and interim periods beginning after November 15, 2008, with early application encouraged. The Company is currently evaluating the impact that FAS No. 161 will have on its financial statements.

In December 2007, the FASB issued SFAS No. 141 (revised 2007), Business Combinations (SFAS No. 141R). SFAS No. 141R establishes principles and requirements for how an acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, any noncontrolling interest in the acquiree and the goodwill acquired. SFAS No. 141R also establishes disclosure requirements to enable the evaluation of the nature and financial effects of the business combination. SFAS No. 141R will be effective for financial statements issued for fiscal years beginning after December 15, 2008. The Company is currently evaluating the potential impact of adoption of SFAS No. 141R on its consolidated financial statements.

In December 2007, the FASB issued SFAS No. 160 Noncontrolling Interests in Consolidated Financial Statements- an Amendment of ARB No. 51 (SFAS No. 160). SFAS No. 160 establishes accounting and reporting standards pertaining to ownership interests in subsidiaries held by parties other than the parent, the amount of net income attributable to the parent and to the noncontrolling interest, changes in a parent s ownership interest, and the valuation of any retained noncontrolling equity investment when a subsidiary is deconsolidated. This statement also establishes disclosure requirements that clearly identify and distinguish between the interests of the parent and the interests of the noncontrolling owners. SFAS No. 160 will be effective for fiscal years beginning on or after December 15, 2008. The Company is currently evaluating the potential impact of adoption of SFAS No. 160 on its consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements, (SFAS No. 157) which defines fair value, establishes guidelines for measuring fair value and expands disclosures regarding fair value measurements. SFAS No. 157 does not require any new fair value measurements but rather eliminates inconsistencies in guidance found in various prior accounting pronouncements. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007. On February 12, 2008, the FASB issued FSP SFAS No. 157-2 (FSP 157-2), which delays the effective date of SFAS No. 157 for all non-financial assets and non-financial liabilities, except those that are recognized or disclosed at fair

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Blackbaud, Inc.

Condensed notes to consolidated financial statements (continued)

(Unaudited)

value in the financial statements on a recurring basis (at least annually). FSP 157-2 partially defers the effective date of SFAS No. 157 to fiscal years beginning after November 15, 2008, and interim periods within those fiscal years for items within the scope of FSP 157-2. In addition, FASB issued a staff position, FSP SFAS No. 157-1, to clarify that SFAS No. 157 does not apply under SFAS No. 13, Accounting for Leases (SFAS No. 13), and other accounting pronouncements that address fair value measurements for purposes of lease classifications under SFAS No. 13. The Company adopted SFAS No. 157 on January 1, 2008, except as it applies to those non-financial assets and non-financial liabilities as noted in FSP 157-2. The major categories of assets and liabilities that are measured at fair value, for which the Company has not yet applied the provisions of SFAS No. 157 include goodwill and long-lived assets subject to impairment tests under SFAS No. 142 and SFAS No. 144. As it applies to non-financial assets and non-financial liabilities, the Company does not expect the adoption of SFAS No. 157, to have a material impact on its consolidated financial position, results of operations or cash flows.

3. Business combinations

eTapestry

On August 1, 2007, the Company acquired eTapestry.com, Inc. (eTapestry), a privately owned company based near Indianapolis, Indiana. eTapestry is the provider of an on-demand fundraising solution. The Company believes that the acquisition of eTapestry will allow it to address a broader market opportunity by providing an on-demand solution that is suited for smaller organizations interested in a relatively low-cost offering and mid-sized nonprofits interested in a stand-alone fundraising solution deployed in an on-demand model. The Company acquired all of the outstanding capital stock of eTapestry for approximately $25,429,000 in a cash transaction financed by a combination of cash on hand and borrowings under the Company s revolving credit facility. An additional amount of up to $1,500,000 is contingently payable to certain eTapestry employees under a stock-based incentive arrangement based upon performance of the acquired business over the two years subsequent to the acquisition date ending on September 30, 2008 and 2009. Amounts paid, if any, under this arrangement will be accounted for as expense when incurred. The results of operations of eTapestry are included in the consolidated financial statements of the Company from the date of acquisition.

Target Companies

On January 16, 2007, the Company acquired Target Software, Inc. and Target Analysis Group, Inc., or the Target Companies, privately owned affiliated companies based in Cambridge, Massachusetts. The two acquired companies provide solutions that help organizations analyze, plan, forecast, execute, and manage high-volume fundraising campaigns while simultaneously helping them maintain long-term constituent relationships. The acquisition of the Target Companies is expected to significantly advance the Company s strategic goal of providing a complete solution that will meet the fundraising and direct marketing needs of the nonprofit sector. The Company acquired all of the outstanding capital stock of the Target Companies for approximately $58,733,000, including direct acquisition-related costs, in an all cash transaction that was financed by a combination of cash on hand and borrowings under the Company s revolving credit facility. An additional amount of up to $2,400,000 was contingently payable to the sellers under an earn-out arrangement based upon performance of the acquired businesses over the year subsequent to the acquisition. The results of operations of the Target Companies are included in the consolidated financial statements of the Company from the date of acquisition.

During the six months ended June 30, 2008, the Company paid $2,327,000 of contingent consideration in connection with the acquisition of the Target Companies on January 16, 2007. The payment was recorded as additional cost of the acquired entity and increased the balance of goodwill. There is no further obligation in connection with the acquisition of the Target Companies.

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Blackbaud, Inc.

Condensed notes to consolidated financial statements (continued)

(Unaudited)

The following unaudited pro forma information presents the consolidated results of operations of the Company as if the acquisition of the Target Companies had taken place at the beginning of 2007. The pro forma information includes the business combination effect of the amortization charges from acquired intangible assets, adjustments to interest income and related tax effects. The pro forma information does not necessarily reflect the actual results that would have occurred nor is it necessarily indicative of future results of operations.

(in thousands, except per share amounts)	Six months ended June 30, 2007
Revenue	$ 119,971
Net income	13,707
Earnings per share, basic	$ 0.32
Earnings per share, diluted	0.31

Campagne

On April 21, 2008, the Company made the final payment of contingent consideration in connection with the 2006 acquisition of Campagne Associates, Ltd. (Campagne). The Company recorded the entire payment of $569,000 as an increase in goodwill. Cumulatively, the Company paid a total of $1,563,000 of the potential $2,500,000 of contingent consideration, there is no further obligation in connection with the acquisition of Campagne.

4. Earnings per share

The Company computes earnings per common share in accordance with SFAS Statement No. 128, Earnings per Share (SFAS No. 128). Under the provisions of SFAS No. 128, basic earnings per share is computed by dividing net income available to common stockholders by the weighted average number of common shares outstanding. 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 then outstanding. Diluted earnings per share reflect the assumed conversion of all dilutive securities, using the treasury stock method. Dilutive potential common shares consist of shares issuable upon the exercise of stock options, shares of non-vested restricted stock and settlement of stock appreciation rights.

Diluted earnings per share for the three months ended June 30, 2008 and 2007 include the effect of 681,101 and 983,480 potential common shares, respectively and for the six months ended June 30, 2008 and 2007 include the effect of 727,447 and 993,783 potential common shares, respectively. There were no anti-dilutive potential common shares outstanding for the three and six months ended June 30, 2008 and 2007.

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

(in thousands, except share and per share amounts)	Three months ended June 30, 2008	Three months ended June 30, 2007	Six months ended June 30, 2008	Six months ended June 30, 2007
Numerator:				
Net income, as reported	$ 8,987	$ 8,203	$ 16,030	$ 13,959
Denominator:				
Weighted average common shares	42,776,609	43,355,261	43,336,989	43,508,166
Add effect of dilutive securities:				
Employee stock options and restricted stock	681,101	983,480	727,447	993,783

Weighted average common shares assuming dilution		43,457,710		44,338,741		44,064,436		44,501,949
Earnings per share:								
Basic	$	0.21	$	0.19	$	0.37	$	0.32
Diluted	$	0.21	$	0.19	$	0.36	$	0.31

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Blackbaud, Inc.

Condensed notes to consolidated financial statements (continued)

(Unaudited)

5. Comprehensive Income

Total comprehensive income for the three and six months ended June 30, 2008 and 2007 was as follows:

(in thousands)	Three months ended June 30, 2008	2007	Six months ended June 30, 2008	2007
Net income	$ 8,987	$ 8,203	$ 16,030	$ 13,959
Foreign currency translation adjustment, net of tax	(54)	45	(46)	(27)
Comprehensive income	$ 8,933	$ 8,248	$ 15,984	$ 13,932

For the three months ended June 30, 2008 and 2007, the amount of income tax expense allocated to foreign currency translation adjustments was benefit of $35,000 and expense of $29,000, respectively. For the six months ended June 30, 2008 and 2007, the amount of income tax benefit allocated to foreign currency translation adjustments was $29,000 and $17,000, respectively.

6. Prepaid expenses and other current assets

Prepaid expenses and other current assets consisted of the following as of June 30, 2008 and December 31, 2007:

(in thousands)	June 30, 2008	December 31, 2007
Taxes, prepaid and receivable	$ 1,344	$ 5,547
Prepaid software maintenance and royalties	3,336	2,131
Deferred sales commissions	2,697	1,903
Other	2,910	1,698
Total prepaid expenses and other current assets	$ 10,287	$ 11,279

7. Accrued expenses and other current liabilities

Accrued expenses and other current liabilities consisted of the following as of June 30, 2008 and December 31, 2007:

(in thousands)	June 30, 2008	December 31, 2007
Accrued bonuses	$ 4,608	$ 6,566
Taxes payable	4,713	3,306
Accrued commissions and salaries	2,470	2,967
Accrued accounting and legal fees	1,345	1,766
Customer credit balances	1,825	1,588
Accrued health care costs	612	1,094
Other	2,607	3,288
Total accrued expenses and other current liabilities	$ 18,180	$ 20,575

8. Revolving credit facility

On July 25, 2007, the Company entered into a new $75,000,000 revolving credit facility. The new revolving credit facility has a term of five years, is guaranteed by the material domestic subsidiaries and is collateralized with the stock of all of the Company s subsidiaries. Amounts borrowed under the revolving credit facility bear interest, at the Company s option, at a variable rate based (a) on the higher of the prime rate plus a margin of up to 0.5% or federal funds rate plus a margin of 0.5% to 1.0% or (b) LIBOR plus a margin of 1.0% to 1.5%. The exact amount of any margin depends on the nature of the loan and the leverage ratio at the time of the borrowing. The Company also pays a quarterly commitment fee of 0.2% to 0.3% per annum on the unused portion of the revolving credit facility, depending on the leverage ratio of the Company. The outstanding balance of the previous credit facility on July 25, 2007 of $10,000,000 was transferred upon its termination on that date to the new credit facility.

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Blackbaud, Inc.

Condensed notes to consolidated financial statements (continued)

(Unaudited)

Also under the terms of the credit agreement, the Company may elect not more than two times to increase the amount available under the facility for an aggregate amount of up to $50,000,000, subject to certain terms and conditions. On June 23, 2008, the Company exercised one of its two options to increase the existing credit facility by $15,000,000 to an aggregate available amount of $90,000,000. Subsequent to exercising this increase, all principal covenants or the financial terms of the facility, noted above, remained unchanged.

During the six months ended June 30, 2008, the Company borrowed $27,200,000 under its credit agreement and repaid $2,700,000. There was $24,500,000 principal outstanding under the credit facility as of June 30, 2008.

9. Commitments and contingencies

The Company currently leases various office space and equipment under operating leases. In addition to operating leases, the Company, through its acquisitions of the Target Companies and eTapestry, has various non-cancellable capital leases for computer equipment and furniture. As of June 30, 2008, the future minimum lease commitments related to these lease agreements, as well as the lease agreements discussed below, net of related sublease commitments, were as follows:

Year ending December 31,

(in thousands)	**Operating leases**	**Capital leases**
2008 - remaining	$ 3,684	$ 296
2009	7,556	405
2010	4,571	167
2011	847	40
2012	650	2
2013 and thereafter	205	-
Total minimum lease payments	$ 17,513	910
Less: portion representing interest		88
Present value of net minimum lease payments		822
Less: current maturities		470
Long-term maturities		$ 352

Lease agreement

On October 13, 1999, the Company entered into a lease agreement for office space with Duck Pond Creek, LLC, which is partially owned by certain current executive officers of the Company. The term of the lease is for ten years with two five-year renewal options by the Company. The current annual base rent of the lease is $4,854,000 payable in equal monthly installments. The base rate escalates annually at a rate equal to the change in the consumer price index, as defined in the agreement.

The Company has subleased a portion of its headquarters facility under various agreements extending through 2008. Under these agreements, rent expense was reduced by $65,000 and $93,000 for the three months ended June 30, 2008 and 2007, respectively and $131,000 and $201,000 for the six months ended June 30, 2008 and 2007, respectively. The operating lease commitments will be reduced by minimum aggregate sublease commitments of $377,000 through 2010. The Company has also received and expects to receive through 2015, quarterly South Carolina state incentive payments as a result of locating its headquarters facility in Berkeley County, South Carolina. These amounts are recorded as a reduction of rent expense and were $703,000 and $482,000 for the three months ended June 30, 2008 and 2007, respectively and $1,100,000 and $846,000 for the six months ended June 30, 2008 and 2007, respectively.

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Blackbaud, Inc.

Condensed notes to consolidated financial statements (continued)

(Unaudited)

Contingent consideration

As discussed in Note 3, Business combinations, the Company has amounts up to $1,500,000 contingently payable to certain eTapestry employees based on the performance of the acquired business over the two years subsequent to the acquisition date.

Other commitments

The Company has a commitment of $200,000 payable annually through 2009 for certain naming rights on a stadium in Charleston, South Carolina. The Company incurred expense under this agreement of $50,000 for each of the three-month periods ended June 30, 2008 and 2007 and $100,000 for each of the six-month periods ended June 30, 2008 and 2007.

The Company utilizes third-party relationships in conjunction with its products. The contractual arrangements vary in length from one to three years. In certain cases, these arrangements require a minimum annual purchase commitment. The aggregate minimum purchase commitment under these arrangements is approximately $555,000 through 2010. The Company incurred expense under these arrangements of $22,000 and $231,000 for the three months ended June 30, 2008 and 2007, respectively and $206,000 and $426,000 for the six months ended June 30, 2008 and 2007, respectively.

Legal contingencies

The Company is subject to legal proceedings and claims that have arisen in the ordinary course of business. In accordance with SFAS No. 5, Accounting for Contingencies, the Company records an accrual for a contingency when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated. The Company does not believe the amount of potential liability with respect to these actions will have a material adverse effect upon the Company s financial position, results of operations or cash flows.

10. Income taxes

The Company calculated its income taxes for the six-month period ended June 30, 2008 using the projected effective tax rate for fiscal 2008 in accordance with SFAS No. 109. The 2008 estimated annual effective tax rate of 39.7%, which excludes period-specific items, was applied as the effective rate for the quarter ended June 30, 2008. The Company s effective tax rate for the three-month periods ended June 30, 2008 and 2007, including the effects of period-specific events, was 38.1% and 38.7%, respectively. As of June 30, 2008, the Company had state tax credits of $10,470,000, $6,805,000 net of federal tax effect, which will expire between 2009 and 2021, if unused. These tax credits had a valuation reserve of approximately $5,987,000, $3,891,000 net of federal tax effect, as of June 30, 2008. The valuation allowance was unchanged during the three and six months ended June 30, 2008.

The Company recorded excess tax benefits on stock option exercises of approximately $18,000 and $709,000 in stockholders equity in the six months ended June 30, 2008 and 2007, respectively.

The Company adopted the provisions of FIN 48 on January 1, 2007. As a result, the Company recognized a $269,000 reduction, including interest and penalties and net of applicable taxes, to the January 1, 2007 balance of retained earnings. During the second quarter of 2008, the Company recognized as a benefit in income tax expense $300,000 of its unrecognized tax benefit and $164,000 of associated interest and penalties due to a certain statute of limitation expiring during the period. The unrecognized tax benefit was $329,000 and $629,000 as of June 30, 2008 and December 31, 2007, respectively. The total amount of unrecognized tax benefits as of June 30, 2008 that, if recognized, would affect the effective tax rate was $214,000. The total amounts of interest and penalties included in the consolidated balance sheets as of June 30, 2008 and December 31, 2007 was $223,000 and $386,000, respectively.

It is reasonably possible that the total amounts of unrecognized tax benefits the Company has recorded for positions taken in certain tax jurisdictions could significantly decrease within the next twelve months. A possible decrease could result from the finalization of state income tax reviews. This position relates to a state nexus issue. The reasonably possible decrease in the next twelve months is $179,000.

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Blackbaud, Inc.

Condensed notes to consolidated financial statements (continued)

(Unaudited)

11. Stockholders equity

Common stock

The Company has authorized 180,000,000 shares of common stock with a par value of $0.001. As of June 30, 2008 and December 31, 2007, 50,499,324 and 50,450,675 shares were issued and 43,565,657 and 45,018,823 shares were outstanding, respectively.

Preferred stock

The Company has authorized 20,000,000 shares of preferred stock. No shares were issued and outstanding at June 30, 2008 and December 31, 2007. The Company's Board of Directors may fix the relative rights and preferences of each series of preferred stock in a resolution of the Board of Directors.

Dividends

On February 5, 2008, the Company s Board of Directors approved an increase to the Company s annual dividend from $0.34 per share to $0.40 per share and declared its first quarter dividend of $0.10 per share, which was paid on March 14, 2008 to stockholders of record on February 28, 2008.

On May 7, 2008, the Company s Board of Directors declared a second quarter dividend of $0.10 per share payable on June 16, 2008 to stockholders on record on May 28, 2008.

Stock repurchase program

On May 7, 2008, the Company s Board of Directors approved a stock repurchase program that authorized the Company to purchase up to $40,000,000 of the Company s outstanding shares of common. The prior program was terminated at that date and the remaining balance of $6,376,383 that was authorized but not used was included in the $40,000,000 authorized under the new plan. The new plan does not have an expiration date. The shares can be purchased from time to time on the open market or in privately negotiated transactions depending upon market conditions and other factors, all in accordance with the requirements of applicable law.

The table below shows the plans under which shares were purchased during the six months ended June 30, 2008:

	Plan date	Shares repurchased	Average price	Cost
New plan	May 7, 2008	64,000	$23.43	1,499,711
Prior plan	June 13, 2007	1,435,745	$24.03	34,497,520
Total		1,499,745	$24.00	35,997,231

In addition to the Company s stock repurchase plan, 2,070 shares, valued at $53,000, were surrendered by holders of restricted stock to the Company to satisfy their tax obligations due upon vesting of restricted stock during the six months ended June 30, 2008.

12. Segment information

The Company has adopted SFAS No. 131, Disclosures about Segments of an Enterprise and Related Information. SFAS No. 131 establishes standards for the reporting by business enterprises of information about operating segments, products and services, geographic areas, and major customers. The method of determining what information is reported is based on the way that management organizes the operating segments within the Company for making operational decisions and assessments of financial performance. The Company has determined that its reportable segments are those that are based upon internal financial reports that disaggregate certain operating information into six reportable segments. The Company s chief operating decision maker, as defined in SFAS No. 131, is its chief executive officer, or CEO.

The CEO uses the information presented in these reports to make certain operating decisions. The CEO does not review any report presenting segment balance sheet information. The segment revenues and direct controllable costs, which

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Blackbaud, Inc.

Condensed notes to consolidated financial statements (continued)

(Unaudited)

include salaries, related benefits, third-party contractors, data expense and classroom rentals, for the three and six months ended June 30, 2008 and 2007 were as follows:

(in thousands)	License fees	Consulting and education services (1)	Analytic services (2)	Maintenance	Subscriptions	Other	Total
Three months ended June 30, 2008							
Revenue	$9,603	$20,217	$5,119	$26,371	$9,010	$2,182	$72,502
Direct controllable costs	764	10,529	2,136	3,582	2,961	2,001	21,973
Segment income	8,839	9,688	2,983	22,789	6,049	181	50,529
Corporate costs not allocated[(3)]							4,181
Operating expenses							31,754
Interest expense, net							114
Other (income), net							(49)
Income before provision for income taxes							$14,529
Three months ended June 30, 2007							
Revenue	$11,030	$18,589	$3,629	$23,164	$5,539	$2,094	$64,045
Direct controllable costs	762	9,626	1,906	3,293	1,698	1,751	19,036
Segment income	10,268	8,963	1,723	19,871	3,841	343	45,009
Corporate costs not allocated[(3)]							3,560
Operating expenses							27,839
Interest expense, net							223
Other expense, net							8
Income before provision for income taxes							$13,379

(in thousands)	License fees	Consulting and education services (1)	Analytic services (2)	Maintenance	Subscriptions	Other	Total
Six months ended June 30, 2008							
Revenue	$19,238	$39,492	$9,420	$51,801	$17,795	$4,192	$141,938
Direct controllable costs	1,563	21,562	4,378	7,265	5,801	3,826	44,395
Segment income	17,675	17,930	5,042	44,536	11,994	366	97,543
Corporate costs not allocated[(3)]							8,502
Operating expenses							63,193
Interest expense, net							19
Other expense, net							40
Income before provision for income taxes							$25,789

Six months ended June 30, 2007							
Revenue	$19,098	$33,935	$6,597	$45,600	$10,331	$3,629	$119,190
Direct controllable costs	1,214	18,506	3,425	6,447	3,173	3,091	35,856
Segment income	17,884	15,429	3,172	39,153	7,158	538	83,334
Corporate costs not allocated[3]							6,635
Operating expenses							53,811
Interest expense, net							219
Other expense, net							77
Income before provision for income taxes							$22,592

(1) This segment consists of consulting, installation and implementation, document imaging, customer training and other educational services.
(2) This segment consists of donor prospect research and data modeling services.
(3) Various corporate costs, such as depreciation, facilities and IT support costs, stock-based compensation and amortization of intangibles arising from business combinations, are not allocated to the segment income because management believes that the exclusion of these costs allows the Company to better understand and manage other operating expenses and cash needs.

13. Subsequent events

On July 8, 2008, the Company acquired Kintera, Inc. (Kintera), a publicly traded company based in San Diego, California. Kintera is a leader in providing on-demand solutions to the nonprofit sector. The acquisition of Kintera adds experience in on-demand solutions and expands the Company s set of online offerings to nonprofit sector. Kintera was acquired through a tender offer, paying $1.12 per Kintera share, for total of approximately $46,000,000 in a tender offer of cash. The Company financed this acquisition with cash on hand and borrowing under the Company s revolving credit facility. As a result of the transaction, Kintera has become a wholly-owned subsidiary of the Company.

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Blackbaud, Inc.

Item 2. Management s discussion and analysis of financial condition and results of operations

The Company will include the operating results of Kintera in its consolidated financial statements from the date of acquisition.

On August 4, 2008, the Company s Board of Directors declared a third quarter dividend of $0.10 per share payable on September 15, 2008 to stockholders of record on August 28, 2008.

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Blackbaud, Inc.

Item 2. Management s discussion and analysis of financial condition and results of operations

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our consolidated financial statements and related notes included elsewhere in this Quarterly Report on Form 10-Q. This report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. These forward-looking statements reflect our current view with respect to future events and financial performance and are subject to risks and uncertainties, including those set forth under Cautionary statement included in this Management s discussion and analysis of financial condition and results of operations and elsewhere in this report, that could cause actual results to differ materially from historical or anticipated results.

Overview

We are the leading global provider of software and related services designed specifically for nonprofit organizations. Our products and services enable nonprofit organizations to increase donations, reduce fundraising costs, improve communications with constituents, manage finances and optimize internal operations. We have focused solely on the nonprofit market since our incorporation in 1982 and have developed our suite of products and services based upon our extensive knowledge of the operating challenges facing nonprofit organizations. As of June 30, 2008, we had approximately 19,000 active customers. Our customers operate in multiple verticals within the nonprofit market, including education, foundations, health and human services, religion, arts and cultural, public and societal benefits, environment and animal welfare and international foreign affairs.

We derive revenue from selling perpetual licenses or charging for the use of our software products and providing a broad offering of services, including consulting, training, installation and implementation, as well as ongoing customer support and maintenance. Consulting, training and implementation are generally not essential to the functionality of our software products and are sold separately. Furthermore, we derive revenue from providing hosting services, performing donor prospect research engagements, selling lists of potential donors, and providing benchmarking studies and data modeling services.

Critical accounting policies and estimates

Our discussion and analysis of financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States (U.S. GAAP). The preparation of these financial statements requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements, the reported amounts of revenue and expenses during the reporting period and related disclosures of contingent assets and liabilities. The most significant estimates and assumptions relate to our revenue recognition, our allowance for sales returns and doubtful accounts, valuation of long-lived and intangible assets and goodwill, stock-based compensation and provision for income taxes, valuation of deferred tax assets and liabilities and contingencies.

We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. On an ongoing basis, we reconsider and evaluate our estimates and assumptions. We are not aware of any circumstances in the past that have caused these estimates and assumptions to be materially wrong. Furthermore, we are not currently aware of any material changes in our business that might cause these assumptions or estimates to differ significantly. In our discussion below of deferred taxes, the most significant asset subject to such assumptions and estimates, we have described the sensitivity of these assumptions or estimates to potential deviations in actual results. Actual results could differ from any of our estimates under different assumptions or conditions.

We believe the critical accounting policies listed below require the use of significant judgments and estimates in the preparation of our consolidated financial statements.

Blackbaud, Inc.

Item 2. Management s discussion and analysis of financial condition and results of operations (continued)

Revenue recognition

Our revenue is generated primarily by selling perpetual licenses or charging for the use of our software products and providing support, training, consulting, technical and other professional services for those products. We make available certain software products for use in hosted application arrangements without licensing perpetual rights to the software (hosted applications). Additionally we provide hosting services to customers who have purchased perpetual rights to certain of our software products (hosting services). We recognize revenue in accordance with:

The American Institute of Certified Public Accountants Statements of Position (SOP) 97-2, Software Revenue Recognition, as modified by SOPs 98-4 and 98-9, as well as Technical Practice Aids issued from time to time by the American Institute of Certified Public Accountants;

The SEC Staff Accounting Bulletin (SAB) No. 104, Revenue Recognition in Financial Statements;

The Emerging Issues Task Force (EITF) Issue No. 00-03, Application of AICPA Statement of Position 97-2 to Arrangements that Include the Right to Use Software Stored on Another Entity s Hardware;

The EITF Issue No. 00-21, Revenue Arrangements with Multiple Deliverables; and

The SOP 81-1, Accounting for Performance of Construction-Type and Certain Production-Type Contracts.

We recognize revenue from the sale of perpetual license rights to software when persuasive evidence of an arrangement exists, the product has been delivered, title and risk of loss have transferred to the customers, the fee is fixed or determinable and collection of the resulting receivable is probable. We deem acceptance of an agreement to be evidence of an arrangement. Delivery occurs when the product is shipped or transmitted. Our typical license agreement does not include customer acceptance provisions; if acceptance provisions are provided, delivery is deemed to occur upon acceptance. We consider the fee to be fixed or determinable unless the fee is subject to refund or adjustment or is not payable within our standard payment terms. We consider payment terms greater than 90 days to be beyond its customary payment terms. We deem collection probable if we expect that the customer will be able to pay amounts under the arrangement as they become due. If we determine that collection is not probable, we postpone recognition of the revenue until collection. We sell software licenses with maintenance and, often times, professional services. We allocate revenue to delivered components, normally the license component of the arrangement, using the residual value method based on objective evidence of the fair value of the undelivered elements, which is specific to us. Fair value for the maintenance services associated with our software licenses is based upon renewal rates stated in our agreements, which vary according to the level of the maintenance program. Fair value of professional services and other products and services is based on sales of these products and services to other customers when sold on a stand-alone basis.

The application of SOP 97-2 requires judgment, including whether a software arrangement includes multiple elements, and if so, whether vendor-specific objective evidence (VSOE) of fair value exists for those elements. As we develop new products, we could experience difficulty in determining VSOE regarding the fair value of those new products. This would result in the deferral of revenue on those transactions until all elements of the arrangement have been delivered or until VSOE is established.

Our services, which include consulting, installation and implementation services, are generally billed based on hourly rates plus reimbursable travel-related expenses. For small service engagements, less than approximately $10,000, we frequently contract for and bill based on a fixed fee plus reimbursable travel-related expenses. We recognize this revenue upon completion of the work performed. When our services include software customization, these services are provided to support customer requests for assistance in creating special reports and other minor enhancements that will assist with efforts to improve operational efficiency and/or to support business process improvements. These services are not essential to the functionality of our software and rarely exceed three months in duration. We recognize revenue as these services are performed. When we enter into larger fixed price contracts, we recognize revenue on a percent-complete basis.

We recognize analytic services revenue from donor prospect research engagements, sales of lists of potential donors, benchmarking studies and data modeling service engagements upon delivery.

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 revenue is recognized only upon the customer attending and completing training. Additionally, we sell a fixed-rate program, which permits customers to attend unlimited training over a specified contract period, typically one year, subject to certain restrictions, and revenue is recognized ratably over this contract period.

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Blackbaud, Inc.

Item 2. Management s discussion and analysis of financial condition and results of operations (continued)

We recognize revenue from maintenance services ratably over the contract term, which is principally one year. Our maintenance contracts also include the right to unspecified product upgrades on an if-and-when available basis. Certain support services are sold in prepaid units of time and recognized as revenue upon their usage.

Subscription revenue includes revenue associated with hosted applications, hosting services, data enrichment services, data management services and online training programs. Subscription-based revenue and any related set-up fees are recognized ratably over the service period of the contract.

To the extent that our customers are billed and/or pay for the above described services in advance of delivery, the amounts are recorded in deferred revenue.

Sales returns and allowance for doubtful accounts

We provide customers a 30-day right of return and maintain a reserve for returns. We estimate the amount of this reserve based on historical experience. Provisions for sales returns are charged against the related revenue items.

We maintain an allowance for doubtful accounts at an amount we estimate to be sufficient to provide adequate protection against losses resulting from extending credit to our customers. In judging the adequacy of the allowance for doubtful accounts, we consider multiple factors including historical bad debt experience, the general economic environment, the need for specific customer reserves and the aging of our receivables. Any necessary provision is reflected in general and administrative expense. A considerable amount of judgment is required in assessing these factors and if any receivables were to deteriorate, an additional provision for doubtful accounts could be required.

Valuation of long-lived and intangible assets and goodwill

We review identifiable intangible and other long-lived assets for impairment when events change or circumstances indicate the carrying amount may not be recoverable. Events or changes in circumstances that indicate the carrying amount may not be recoverable include, but are not limited to, a significant decrease in the market value of the business or asset acquired, a significant adverse change in the extent or manner in which the business or asset acquired is used or significant adverse change in the business climate. If such events or changes in circumstances occur, we use the undiscounted cash flow method to determine whether the asset is impaired. Cash flows would include the estimated terminal value of the asset and exclude any interest charges. To the extent that the carrying value of the asset exceeds the undiscounted cash flows over the estimated remaining life of the asset, we measure the impairment using discounted cash flows. The discount rate utilized would be based on our best estimate of our risks and required investment returns at the time the impairment assessment is made.

In accordance with the Financial Accounting Standards Board s (FASB) Statement of Financial Accounting Standards (SFAS) No. 142, Goodwill and Other Intangible Assets (SFAS No. 142), we test goodwill for impairment annually, or more frequently if events or changes in circumstances indicate that the asset might be impaired. The impairment test compares the fair value of the reporting unit with its carrying amount. If the carrying amount exceeds its fair value, impairment is indicated. The impairment is measured as the excess of the recorded goodwill over its fair value, which could materially adversely impact our financial position and results of operations. Goodwill is assigned to various reporting units.

Stock-based compensation

We account for stock-based compensation in accordance the provisions of FASB s Statement No. 123 (revised 2004), Share-Based Payment (SFAS No. 123(R)). Under the fair value recognition provisions of this statement, stock-based compensation cost is measured at the grant date based on the fair value of the award and is recognized as expense over the requisite service period, which is the vesting period.

We determine the fair value of the stock options and stock appreciation rights using an option pricing model, which requires us to use significant judgment to make estimates regarding the life of the award, volatility of our stock price, the risk-free interest rate and the dividend yield of our stock over the life of the award. Changes to these estimates would result in different fair values of awards.

SFAS No. 123(R) requires us to estimate the number of awards that will be forfeited and recognize expense only for those awards that ultimately vest. Significant judgment is required in determining the adjustment to compensation expense for

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estimated forfeitures. Compensation expense in a period could be impacted, favorably or unfavorably, by differences between forfeiture estimates and actual forfeitures.

We adopted SFAS No. 123(R) on January 1, 2006 using the modified prospective method. Under the modified prospective application method, prior periods are not revised for comparative purposes. The provisions of SFAS No. 123(R) apply to grants made after the adoption date and existing grants which were partially unvested at that date. Compensation expense for grants outstanding on the date of adoption are recognized over the remaining service period using the grant date fair values and amortization methods determined previously for the SFAS No. 123, Accounting for Stock-Based Compensation, pro forma disclosures.

Provision for income tax and valuation of deferred tax assets

We account for income taxes using the asset and liability approach as prescribed by SFAS Statement No. 109, Accounting for Income Taxes. This approach requires recognition of deferred tax assets and liabilities for the expected future tax consequences of events that have been included in the consolidated financial statements or income tax returns. Using the enacted tax rates in effect for the year in which we expect the differences to reverse, we determine deferred tax assets and liabilities based on the differences between the financial reporting and the tax basis of an asset or liability. We record a valuation allowance when it is more likely than not that the deferred tax asset will not be realized.

Significant judgment is required in determining our income taxes in each of the jurisdictions in which we operate. This process involves estimating our actual current tax exposure together with assessing temporary differences resulting from differing treatment of items, such as deferred revenue, for tax and accounting purposes. These differences result in a net deferred tax asset, which is included on our consolidated balance sheets. The final outcome of these matters for tax reporting purposes might be different than that which is reflected in our historical income tax provisions, benefits and accruals. Any difference could have a material effect on our income tax provision and net income in the period in which such a determination is made.

Prior to October 13, 1999, we were organized as an S corporation under the Internal Revenue Code and, therefore, were not subject to federal income taxes. In addition, as a result of our S corporation status we were not subject to income tax in many of the states in which we operated. We historically made distributions to our stockholders to cover the stockholders anticipated tax liability. In connection with our 1999 recapitalization, we converted our U.S. taxable status from an S corporation to a C corporation. Accordingly, since October 14, 1999 we have been subject to federal and state income taxes. Upon the conversion and in connection with the recapitalization, we recorded a one-time benefit of $107.0 million to establish a deferred tax asset.

We must assess the likelihood that the net deferred tax asset will be recovered from future taxable income and to the extent we believe that recovery is not likely, we must establish a valuation allowance. To the extent we establish a valuation allowance, we must include an expense within the tax provision in the statements of operations. Except with respect to certain state income tax credits, we did not record a valuation allowance as of June 30, 2008 and December 31, 2007, because we expect to be able to utilize our entire net deferred tax asset. The ability to utilize our net deferred tax asset is solely dependent on our ability to generate future taxable income. Based on current estimates of revenue and expenses, we expect future taxable income will be more than sufficient to recover the annual amount of additional tax deductions permitted. Even if actual results are significantly below our current estimates, the recovery still remains likely and no valuation allowance would be necessary.

Significant judgment is required in determining the provision for income taxes. To the extent that the final results differ from these estimated amounts that were initially recorded, such differences will impact the income tax provision in the period in which such determination is made and could have an impact on the deferred tax asset. Our deferred tax assets and liabilities are recorded at an amount based upon a U.S. federal income tax rate of 35.0%. If our projected taxable income falls and our tax rate decreases, we will adjust our deferred tax assets and liabilities to an amount reflecting a reduced expected U.S. federal income tax rate. If such change is determined to be appropriate, it will affect the provision for income taxes during the period that the determination is made.

We adopted FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109, Accounting for Income Taxes, (FIN 48) on January 1, 2007. Under FIN 48 we must recognize the tax impact from an uncertain tax position only if it is more likely than not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax impact recognized in the financial statements from such a position is measured based on the largest benefit that has a greater than 50% likelihood of

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being realized upon ultimate resolution. Penalties and interest related to uncertain tax positions are recorded as tax expense. Significant judgment is required in the identification of uncertain tax positions and in the estimation of penalties and interest on uncertain tax positions.

Contingencies

We are subject to the possibility of various loss contingencies in the normal course of business. In accordance with SFAS No. 5, Accounting for Contingencies, we record an accrual for a contingency when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated. Often these issues are subject to substantial uncertainties and, therefore, the probability of loss and an estimation of damages are difficult to ascertain. These assessments can involve a series of complex judgments about future events and can rely heavily on estimates and assumptions that have been deemed reasonable by us. Although we believe we have substantial defenses in these matters, we could in the future incur judgments or enter into settlements of claims that could have a material adverse effect on our financial position, results of operations or cash flows in any particular period.

Results of operations

Comparison of the three months and six months ended June 30, 2008 and 2007

We completed the acquisition of Target Software, Inc. and Target Analysis Group, Inc., together referred to as the Target Companies, on January 16, 2007. Additionally, we completed the acquisition of eTapestry.com, Inc., referred to as eTapestry, on August 1, 2007. The results of operations from the Target Companies and eTapestry are included in our consolidated results of operations from the dates of their respective acquisition.

On July 8, 2008, we completed the acquisition of Kintera, Inc. (Kintera). As this transaction took place outside the periods reported in this quarterly report, the results of operations for the three and six months ended June 30, do not include the activities of Kintera.

Revenue

The table below compares revenue from our statements of operations for the three and six months ended June 30, 2008 with the same periods in 2007.

	Three months ended June 30,				Six months ended June 30,			
(in millions)	**2008**	**2007**	**Change**	**% Change**	**2008**	**2007**	**Change**	**% Change**
License fees	$ 9.6	$ 11.0	$ (1.4)	(13)%	$ 19.2	$ 19.1	$ 0.1	1%
Services	25.3	22.2	3.1	14%	48.9	40.6	8.3	20%
Maintenance	26.4	23.2	3.2	14%	51.8	45.6	6.2	14%
Subscriptions	9.0	5.5	3.5	64%	17.8	10.3	7.5	73%
Other	2.2	2.1	0.1	5%	4.2	3.6	0.6	17%
Total revenue	$ 72.5	$ 64.0	$ 8.5	13%	$ 141.9	$ 119.2	$ 22.7	19%

Total revenue increased $8.5 million, or 13%, in the second quarter of 2008 compared to the second quarter of 2007. A total of $2.5 million or 29% of this increase was attributable to the inclusion of eTapestry in our consolidated results of operations. The remaining increase in revenue in the second quarter of 2008 is primarily due to growth in services to new and existing customers partially due to the introduction of new product offerings. Also contributing to the growth is revenue from new maintenance contracts associated with new license agreements and annual inflationary rate adjustments associated with existing client contracts and revenue from our subscription offerings. Offsetting these increases is a $1.4 million decrease in license fee revenue, which is principally due to fewer sales to new customers.

Total revenue increased $22.7 million, or 19%, in the first six months of 2008 compared to the first six months of 2007. A total of $4.8 million or 21% of this increase was attributable to the inclusion of eTapestry in our consolidated results of operations. The remaining increase in revenue in the first six months of 2008 is primarily due to growth in services to new and existing customers partially due to the introduction of new product offerings. Also contributing to the growth is revenue from new maintenance contracts associated with new license agreements and annual inflationary rate adjustments associated with existing client contracts and revenue from our subscription offerings.

Subscription revenue grew 64% and 73% for the three and six months ended June 30, 2008, respectively, when compared to the same periods in 2007. Of the increase in subscription revenue for the three and six months ended June 30, 2008, $1.9 million and $3.6 million, respectively, or 54% and 48%, respectively, of the growth is attributable to the inclusion of

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eTapestry. The remaining $1.6 million and $3.9 million increase in subscription revenue in the three and six months ended June 30, 2008, respectively, is largely the result of growth in our hosting business and Netsolutions and other analytic offerings.

Segment results

We analyze our business according to our six operating segments as identified in Note 12, which are license fees, consulting and education services, analytic services, maintenance, subscriptions and other. The analyses provided below are presented on a non-GAAP basis before the inclusion of various allocable corporate costs such as depreciation, facilities and IT support costs, stock-based compensation and amortization of intangibles arising from business combinations because, in managing our operations, we believe that the exclusion of these costs allows us to better understand and manage other operating expenses and cash needs. These excluded costs are analyzed separately following the segment results analysis.

License fees

	Three months ended June 30,				Six months ended June 30,			
(in millions)	**2008**	**2007**	**Change**	**% Change**	**2008**	**2007**	**Change**	**% Change**
License fee revenue	$ 9.6	$ 11.0	$ (1.4)	(13)%	$ 19.2	$ 19.1	$ 0.1	1%
Direct controllable cost of license fees	0.8	0.8	-	0%	1.6	1.2	0.4	33%
Segment income	$ 8.8	$ 10.2	$ (1.4)	(14)%	$ 17.6	$ 17.9	$ (0.3)	(2)%
Segment margin %	92%	93%			92%	94%		

Revenue from license fees is derived from the sale of our software products, under a perpetual license agreement. The decrease in license fee revenue in the second quarter of 2008 is principally attributable to a $1.5 million decrease in sales to new clients resulting from the challenging economic environment.

Direct controllable cost of license fees includes third-party software royalties and costs of shipping software products to our customers. The cost of license fees remained flat in absolute terms in the second quarter of 2008 compared to the same period of the previous year.

License fee revenue in the first six months of 2008was relatively constant with prior year levels, after reflecting the decrease in software sales to new clients in the second quarter (see discussion in Revenue above).

The increase in cost of license fees in the first six months of 2008 is principally due to an increase of $0.3 million in other third-party software costs for various products.

Consulting and education services

	Three months ended June 30,				Six months ended June 30,			
(in millions)	**2008**	**2007**	**Change**	**% Change**	**2008**	**2007**	**Change**	**% Change**
Consulting and education services revenue	$ 20.2	$ 18.6	$ 1.6	9%	$ 39.5	$ 34.0	$ 5.5	16%
Direct controllable cost of consulting and education services	10.5	9.6	0.9	9%	21.6	18.5	3.1	17%
Segment income	$ 9.7	$ 9.0	$ 0.7	8%	$ 17.9	$ 15.5	$ 2.4	15%
Segment margin %	48%	48%			45%	46%		

Consulting and education services revenue consists of consulting, installation, implementation and education services. Consulting, installation and implementation services involve converting data from a customer s existing system, assisting in file set up and system configuration, and/or process re-engineering. Education services principally involve customer training activities.

The rates charged for our service offerings have remained relatively constant year over year and, as such, the increase in revenue in the second quarter of 2008 is principally the result of increased volume of services provided. Of the $1.6 million increase in revenue in the second quarter of 2008, $0.5 million was attributable to the inclusion of eTapestry. The increase in revenue is comprised of a $1.2 million increase in consulting, installation and implementation services delivered and a $0.4 million increase in education services delivered.

Cost of consulting and education services is principally comprised of human resource costs, third-party contractor expenses, classroom rentals and other costs incurred in providing consulting, installation and implementation services and

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customer training. During the second quarter of 2008, salary, benefit and bonus expense increased $0.9 million compared to the second quarter of 2007 because we increased headcount over the course of 2007 to meet growing customer demand. A total of $0.2 million, or 22% of the increase in salary, benefits and bonus expense is due to the inclusion of headcount associated with the acquisition of eTapestry.

During the first six months of 2008, consulting and education revenue increased $5.5 million compared to the first six months of 2007, of which $0.9 million is attributed to the inclusion of eTapestry. The increase in revenue is comprised of a $4.0 million increase in consulting, installation and implementation services delivered and a $1.5 million increase in education services delivered. Of this increase in education services, $0.7 million is attributable to Training Pass, our fixed-rate program, which permits customers to attend unlimited training over a specified contract period.

During the first six months of 2008, salary, benefit and bonus expense increased $3.0 million compared to the first six months of 2007 as we increased headcount over the course of 2007 to meet growing customer demand. A total of $0.3 million, or 10% of the increase in salary, benefits and bonus expense is due to the inclusion of headcount associated with the acquisition of eTapestry. Travel-related expenses, training supplies and other costs increased $0.3 million. These increases were partially offset by a decrease in recruiting and relocation costs and contracted services of $0.2 million.

Analytic services

	Three months ended June 30,				Six months ended June 30,			
(in millions)	2008	2007	Change	% Change	2008	2007	Change	% Change
Analytic services revenue	$ 5.1	$ 3.6	$ 1.5	42%	$ 9.4	$ 6.6	$ 2.8	42%
Direct controllable cost of analytic services	2.1	1.9	0.2	11%	4.4	3.4	1.0	29%
Segment income	$ 3.0	$ 1.7	$ 1.3	76%	$ 5.0	$ 3.2	$ 1.8	56%
Segment margin %	59%	47%			53%	48%		

Analytic services, which are comprised of donor prospect research, benchmarking studies and data modeling services, involve the assessment of current and prospective donor information of the customer. These assessments are performed using our proprietary analytical tools. The end product enables the customer to more effectively target its fundraising activities. Revenue from analytic services increased 42% in the second quarter of 2008 compared to the second quarter of 2007. The increase in analytic services is comprised of a $1.5 million increase in donor prospect research, sales of lists of potential donors, benchmarking studies and data modeling services delivered, of which less than $0.1 million is attributable to eTapestry.

Cost of analytic services is primarily comprised of human resource costs and data expense incurred to perform analytic services. Salary, benefits and bonus expense increased $0.4 million in the second quarter of 2008 compared to the second quarter of 2007.

Revenue from analytic services increased 42% in the first six months of 2008 compared to the first six months of 2007. The increase in analytic services is comprised of a $2.8 million increase in donor prospect research, sales of lists of potential donors, benchmarking studies and data modeling services delivered, of which less than $0.2 million is attributable to eTapestry.

Salary, benefits and bonus expense increased $1.0 million in the first six months of 2008 compared to the first six months of 2007 as we increased headcount to meet the increased customer demand.

Maintenance

(in millions)	Three months ended June 30, 2008	2007	Change	% Change	Six months ended June 30, 2008	2007	Change	% Change
Maintenance revenue	$ 26.4	$ 23.2	$ 3.2	14%	$ 51.8	$ 45.6	$ 6.2	14%
Direct controllable cost of maintenance	3.6	3.3	0.3	9%	7.3	6.4	0.9	14%
Segment income	$ 22.8	$ 19.9	$ 2.9	15%	$ 44.5	$ 39.2	$ 5.3	14%
Segment margin %	86%	86%			86%	86%		

Revenue from maintenance is comprised of annual fees derived from maintenance contracts associated with new software licenses and annual renewals of existing maintenance contracts. These contracts provide customers updates, enhancements and upgrades to our software products as well as online, telephone and email support. The maintenance revenue increase in the second quarter of 2008 compared to the second quarter of 2007 is comprised of $3.4 million of new maintenance

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contracts associated with new license agreements and $0.6 million from maintenance contract inflationary rate adjustments, offset by $1.1 million of maintenance contracts that were not renewed.

Direct controllable cost of maintenance is primarily comprised of human resource costs, third-party royalty costs, and other costs incurred in providing support and related services to our customers. During the second quarter of 2008 the cost of maintenance increase is principally the result of a $0.3 million increase in salary, benefits and bonus expense.

The maintenance revenue increase in the first six months of 2008 compared to the first six months of 2007 is comprised of $6.7 million of new maintenance contracts associated with new license agreements, $0.4 million from maintenance agreements associated with customers of the Target Companies and $1.2 million from maintenance contract inflationary rate adjustments, offset by $2.2 million of maintenance contracts that were not renewed.

During the first six months of 2008 the cost of maintenance increase is principally the result of a $0.6 million increase in salary, benefits and bonus expense.

Subscriptions

(in millions)	Three months ended June 30, 2008	Three months ended June 30, 2007	Change	% Change	Six months ended June 30, 2008	Six months ended June 30, 2007	Change	% Change
Subscriptions revenue	$ 9.0	$ 5.5	$ 3.5	64%	$ 17.8	$ 10.3	$ 7.5	73%
Direct controllable cost of subscriptions	3.0	1.7	1.3	76%	5.8	3.2	2.6	81%
Segment income	$ 6.0	$ 3.8	$ 2.2	58%	$ 12.0	$ 7.1	$ 4.9	69%
Segment margin %	67%	69%			67%	69%		

Revenue from subscriptions is principally comprised of revenue from providing access to hosted applications, providing application hosting services, and access to certain data services and our online subscription training offerings. The increase in subscriptions revenue in the second quarter of 2008 compared to the second quarter of 2007 is principally due to a $2.6 million increase in revenue from hosted applications, of which $1.9 million is attributable to eTapestry. Additionally, revenue from application hosting services increased $0.5 million and revenue from our online analytics products increased $0.4 million.

Direct controllable cost of subscriptions is primarily comprised of human resource costs, third-party royalty and data expenses, hosting expenses, and other costs incurred in providing support and services to our customers. The increase in the cost of subscriptions in the second quarter of 2008 compared to the second quarter of 2007 is principally due to an increase in salary, benefits and bonus expenses, which increased $0.9 million, of which $0.3 million is due to the inclusion of eTapestry. Additionally, data expense, hosting and other costs increased $0.4 million, of which $0.1 million is attributed to the inclusion of eTapestry.

The increase in subscriptions revenue in the first six months of 2008 compared to the first six months of 2007 is principally due to a $5.3 million increase in revenue from hosted applications, of which $3.6 million, or 68%, is attributable to the inclusion of eTapestry. Additionally, revenue from application hosting services increased $1.1 million and revenue from our online analytics products increased $1.0 million.

The increase in the cost of subscriptions in the first six months of 2008 compared to the first six months of 2007 is principally due to an increase in salary, benefits and bonus expenses, which increased $1.9 million, of which $0.6 million is due to the inclusion of eTapestry. Additionally, data expense, hosting and other costs increased $0.5 million, of which $0.1 million is attributed to the inclusion of eTapestry.

Other revenue

(in millions)	Three months ended June 30, 2008	2007	Change	% Change	Six months ended June 30, 2008	2007	Change	% Change
Other revenue	$ 2.2	$ 2.1	$ 0.1	5 %	$ 4.2	$ 3.6	$ 0.6	17 %
Direct controllable cost of other revenue	2.0	1.8	0.2	11 %	3.8	3.1	0.7	23 %
Segment income	$ 0.2	$ 0.3	$ (0.1)	(33)%	$ 0.4	$ 0.5	$ (0.1)	(20)%
Segment margin %	9%	14%			10%	14%		

Other revenue includes the sale of business forms used in conjunction with our software products; reimbursement of travel and related expenses, primarily incurred during the performance of services at customer locations; fees from user

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conferences; and sale of hardware in conjunction with The Patron Edge. Other revenue remained relatively constant with 2007 levels in the second quarter.

Direct controllable cost of other revenue includes human resource costs, costs of business forms and reimbursable expense relating to the performance of services at customer locations. The increase in the second quarter of 2008 compared to the second quarter of 2007 is due to a $0.4 million increase in conference costs offset by a decrease of $0.2 million in reimbursable expenses related to providing services at customer locations.

Other revenue increased in the first six months of 2008 primarily due to a $0.3 million increase in reimbursable travel-related costs from our services businesses.

The increase in the cost of other revenue in the first six months of 2008 compared to the first six months of 2007 is due to a $0.3 million increase in reimbursable expenses related to providing services at customer locations and a $0.4 million increase in conference costs.

U.S. GAAP gross profit

Segment income does not include an allocation of corporate costs, stock-based compensation expense and amortization expense. The following schedule reconciles total segment income to gross profit as stated on the statements of operations.

	Three months ended June 30,				Six months ended June 30,			
(in millions)	2008	2007	Change	% Change	2008	2007	Change	% Change
License fees	$ 8.8	$ 10.2	$ (1.4)	(14)%	$ 17.6	$ 17.9	$ (0.3)	(2)%
Consulting and education services	9.7	9.0	0.7	8%	17.9	15.5	2.4	15%
Analytic services	3.0	1.7	1.3	76%	5.0	3.2	1.8	56%
Maintenance	22.8	19.9	2.9	15%	44.5	39.2	5.3	14%
Subscriptions	6.0	3.8	2.2	58%	12.0	7.1	4.9	69%
Other	0.2	0.3	(0.1)	(33)%	0.4	0.5	(0.1)	(20)%
Total segment income	$ 50.5	$ 44.9	$ 5.6	12%	$ 97.4	$ 83.4	$ 14.0	17%
Less corporate costs not allocated to segment expenses:								
Stock-based compensation	0.5	0.2	0.3	150%	1.0	0.5	0.5	100%
Amortization of intangible assets acquired in business combinations	0.9	0.5	0.4	80%	1.8	1.2	0.6	50%
Corporate overhead costs	2.8	2.8	-	- %	5.6	5.0	0.6	12%
Gross profit as stated in statements of operations	$ 46.3	$ 41.4	$ 4.9	12%	$ 89.0	$ 76.7	$ 12.3	16%
Gross margin %	64%	65%			63%	64%		

Stock-based compensation expense and amortization expense are analyzed separately following the operating expenses section.

Allocated corporate overhead costs are comprised of depreciation, facilities and IT support costs. The increase in the second quarter of 2008 compared to 2007 is primarily the result of an increase in allocated depreciation expense of $0.2 million as the result of property and equipment acquired during the interim period.

The increase in allocated corporate overhead costs in the first six months of 2008 compared to 2007 is comprised of an increase in allocated depreciation of $0.4 million and an increase in allocated facilities costs of $0.4 million. Depreciation increased primarily as the result of property and equipment acquired during the interim period. Allocated facilities costs increased primarily as the result of higher maintenance costs related to hardware and software.

Operating expenses

The operating expenses analyzed below are presented on a non-GAAP basis as they exclude stock-based compensation expense. We believe that the exclusion of these costs allows us to better understand and manage other operating expenses and cash needs. Stock-based compensation expense is analyzed, in total, in the section following the operating expense analysis.

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Sales and marketing

(in millions)	Three months ended June 30, 2008	2007	Change	% Change	Six months ended June 30, 2008	2007	Change	% Change
Sales and marketing expense excluding stock-based compensation	$ 15.4	$ 14.0	$ 1.4	10%	$ 30.3	$ 26.6	$ 3.7	14%
Percentage of revenue	21%	22%			21%	22%		

Sales and marketing expense includes salaries and related human resource costs, travel-related expenses, sales commissions, advertising and marketing materials, public relations and an allocation of depreciation, facilities and IT support costs. The increase in sales and marketing expense in the second quarter of 2008 compared to the second quarter of 2007 is principally due to increases in the size of our sales force and the inclusion of eTapestry. During the second quarter of 2008, salaries, benefits and bonus expense increased $1.0 million, of which $0.5 million is due the inclusion of eTapestry. Other increases include higher advertising and marketing materials expenses of $0.6 million. These increases were partially offset by a decrease in recruiting and relocation and travel-related costs of $0.3 million.

The increase in sales and marketing expense in the first six months of 2008 compared to the first six months of 2007 is principally due to increases in the size of our sales force and the inclusion of eTapestry. During the first six months of 2008, salaries, benefits and bonus expense increased $2.3 million, of which $1.0 million is due the inclusion of headcount associated with the acquisition of eTapestry. Additionally, commission expenses increased $0.5 million due to higher commissionable sales. Other increases include higher allocated costs of $0.4 million and higher advertising and marketing expenses of $0.7 million. These increases were partially offset by a decrease in recruiting and relocation and travel-related costs of $0.2 million.

Research and development

(in millions)	Three months ended June 30, 2008	2007	Change	% Change	Six months ended June 30, 2008	2007	Change	% Change
Research and development expense excluding stock-based compensation	$ 8.1	$ 6.7	$ 1.4	21%	$ 16.4	$ 13.2	$ 3.2	24%
Percentage of revenue	11%	10%			12%	11%		

Research and development expenses include salaries and related human resource costs, third-party contractor expenses, software development tools and other expenses related to developing new products, upgrading and enhancing existing products and an allocation of depreciation, facilities and IT support costs. During the second quarter of 2008, the increase in research and development costs is primarily due to a $1.3 million increase in salaries, benefits and bonus expense due to an increase in headcount as we expanded our investment in our products.

During the first six months of 2008, the increase in research and development costs is primarily due to a $2.6 million increase in salaries, benefits and bonus expense resulting from an increase in headcount and increased investment in this area of which $0.4 million is due to the inclusion of eTapestry. Further increases of $0.3 million are attributable to higher allocated costs and a further $0.2 million higher contracted services, recruiting and other costs.

Research and development as a percentage of revenue increased 1% point for both the three and six months ended June 30, 2008, respectively, compared to the same period in 2007 although absolute dollar expenses increased 21% and 24%, respectively, during this period.

General and administrative

	Three months ended June 30,				Six months ended June 30,			
(in millions)	**2008**	**2007**	**Change**	**% Change**	**2008**	**2007**	**Change**	**% Change**
General and administrative expense excluding stock-based compensation	$ 6.2	$ 5.6	$ 0.6	11%	$ 12.4	$ 10.7	$ 1.7	16%
Percentage of revenue	9%	9%			9%	9%		

General and administrative expense consists primarily of human resource costs for general corporate functions, including finance, accounting, legal, human resources, corporate development, third-party professional fees, insurance, an allocation of depreciation, facilities and IT support, and other administrative expenses. During the second quarter of 2008, general and administrative expenses increased $0.6 million compared to the second quarter of 2007, of which $0.2 million is

Blackbaud, Inc.

Item 2. Management s discussion and analysis of financial condition and results of operations (continued)

attributed to the inclusion of eTapestry. This increase of $0.6 million was primarily driven by an increase in salaries, benefits and bonus expense associated with additional headcount.

During the first six months of 2008, general and administrative expenses increased $1.7 million compared to the first six months of 2007, of which $0.4 million is attributed to the inclusion of eTapestry. The remaining increase of $1.3 million was primarily driven by a $1.2 million increase in salaries, benefits and bonus expense associated with additional headcount.

Stock-based compensation

Beginning on January 1, 2006, we adopted SFAS No. 123(R), using the modified prospective transition method. SFAS No. 123(R) requires us to recognize compensation expense related to stock-based awards granted to employees.

Our consolidated statements of operations for the second quarter and first six months of 2008 and 2007 includes the amounts of stock-based compensation illustrated below:

	Three months ended June 30,				Six Months ended June 30,			
(in thousands)	**2008**	**2007**	**Change**	**% Change**	**2008**	**2007**	**Change**	**% Change**
Included in cost of revenue:								
Cost of services	$ 302	$ 182	$ 120	66%	$ 652	$ 339	$ 313	92%
Cost of maintenance	119	52	67	129	231	99	132	133
Cost of subscriptions	58	11	47	427	85	21	64	305
Total included in cost of revenue	479	245	234	96	968	459	509	111
Included in operating expenses:						-		
Sales and marketing	295	261	34	13	581	521	60	12
Research and development	508	266	242	91	1,028	535	493	92
General and administrative	1,037	1,027	10	1	2,101	1,996	105	5
Total included in operating expenses	1,840	1,554	286	18	3,710	3,052	658	22
Total	$ 2,319	$ 1,799	$ 520	29%	$ 4,678	$ 3,511	$ 1,167	33%

Stock-based compensation is comprised of expense from stock options, restricted stock awards and stock appreciation rights. The table below summarizes the stock-based compensation by award type for the second quarter and first six months of 2008 and 2007.

	Three months ended June 30,				Six months ended June 30,			
(in thousands)	**2008**	**2007**	**Change**	**% Change**	**2008**	**2007**	**Change**	**% Change**
Stock-based compensation from:								
Stock options	$ 306	$ 650	$ (344)	(53)%	$ 668	$ 1,408	$ (740)	(53)%
Restricted stock awards	1,534	973	561	58	3,077	1,762	1,315	75
Stock appreciation rights	479	176	303	172	933	341	592	174
Total stock-based compensation	$ 2,319	$ 1,799	$ 520	29%	$ 4,678	$ 3,511	$ 1,167	33%

The decrease in stock-based compensation from stock options in the second quarter and first six months of 2008 compared to the same periods of 2007 is the result of using the accelerated method for recognizing stock-based compensation expense associated with stock options. This method results in the recognition of more expense in the earlier periods of vesting when compared with the straight-line method of amortization, which results in equal amounts of expense in all vesting periods. Furthermore, there have been no new grants of stock options since 2005. The decrease in expense from stock options is more than offset by an increase in compensation expense from restricted stock awards due to an increase in number of awards granted and their associated amortization. Additionally, grants of stock appreciation rights, which began in the fourth quarter of 2006, contributed to an increase in stock-based compensation expense for the second quarter and first six months of 2008 compared to the same periods of 2007 as more rights have been granted.

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Blackbaud, Inc.

Item 2. Management s discussion and analysis of financial condition and results of operations (continued)

Amortization

We allocate amortization expense is allocated according to the nature of the respective identifiable intangible asset and, to the extent associated directly with revenue, we allocate amortization expense to the respective cost of revenue. Amortization expense included in our consolidated statements of operations for the second quarter and first six months of 2008 and 2007 is illustrated below:

	Three months ended June, 30				Six months ended June 30,			
(in thousands)	**2008**	**2007**	**Change**	**% Change**	**2008**	**2007**	**Change**	**% Change**
Included in cost of revenue:								
Cost of license fees	$ 43	$ 43	$ -	- %	$ 86	$ 67	$ 19	28 %
Cost of services	334	312	22	7	668	533	135	25
Cost of maintenance	98	103	(5)	(5)	196	181	15	8
Cost of subscriptions	409	214	195	91	818	403	415	103
Cost of other revenue	19	21	(2)	(10)	38	37	1	3
Total included in cost of revenue	903	693	210	30	1,806	1,221	585	48
Included in operating expenses	167	98	69	70	334	182	152	84
Total	$ 1,070	$ 791	$ 279	35 %	$ 2,140	$ 1,403	$ 737	53 %

The increase in amortization expense for the three and six months ended June 30, 2008 compared to the same periods in 2007 is directly attributable to the acquisition of the Target Companies and eTapestry, which resulted in the recognition of approximately $32.8 million in identifiable intangible assets with lives ranging from 5 to 15 years. We expect amortization expense to increase in the future due to the closing of our acquisition of Kintera in July 2008.

Interest expense

Interest expense decreased approximately $0.2 million in the second quarter of 2008 compared with the second quarter of 2007. Interest expense decreased $0.5 million from $0.7 in the first six months of 2007 to $0.2 million in the first six months of 2008. The decreases in interest expense during the two periods is directly related to the lesser amount and duration of borrowing under our credit facility during 2008. We expect interest expense to increase in the third quarter of 2008 as a result of increased borrowing to fund the Kintera acquisition in July 2008.

Income tax provision

We record income tax expense in our consolidated financial statements based on an estimated annual effective income tax rate, prior to any quarter-specific items. The 2008 estimated annual effective tax rate of 39.7%, which excludes period-specific items, was applied as the effective rate for the three and six months ended June 30, 2008. Our actual effective rates for the three-months ended June 30, 2008 and 2007 were 38.1% and 38.7%, respectively.

We record our deferred tax assets and liabilities at an amount based upon a U.S. federal income tax rate of 35.0% and appropriate statutory tax rates of foreign, state and local jurisdictions in which we operate. If our tax rates change in the future, we may adjust our deferred tax assets and liabilities to an amount reflecting those income tax rates. Any such change will affect the provision for income taxes during the period that the determination is made.

We adopted the provisions of FIN 48 on January 1, 2007. As a result of the implementation of FIN 48, we recognized a $0.3 million reduction to the January 1, 2007 balance of retained earnings. The total amount of unrecognized tax benefits as of June 30, 2008 and December 31, 2007 was $0.3 million and $0.6 million, respectively, of which $0.2 million and $0.4 million, respectively, would impact our effective rate if recognized. The decrease in unrecognized tax benefit resulted from the release of a liability due to the expiration of a statute of limitation during the second quarter. The release of this liability reduced our provision for tax expense by $0.3 million in the three and six months ended June 30, 2008. As of June 30, 2008 and December 31, 2007, the total amount of accrued interest and penalties included in the consolidated balance sheets was $0.2

million and $0.3 million, respectively.

It is reasonably possible that the total amounts of unrecognized tax benefits the Company has recorded for certain tax jurisdictions could significantly change in the next twelve months. A possible decrease could result from the finalization of state income tax reviews The amount of the reasonably possible decrease in the next twelve months is $0.2 million.

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Blackbaud, Inc.

Item 2. Management s discussion and analysis of financial condition and results of operations (continued)

Liquidity and capital resources

At June 30, 2008, cash and cash equivalents totaled $10.0 million, compared to $14.8 million at December 31, 2007. The $4.8 million decrease in cash and cash equivalents during the first six months of 2008 is principally the result of:

- generating $21.5 million of cash from operations; and
- receiving $27.2 million in proceeds from the use of our credit facility which we used for short-term needs;

offset by:

- $36.0 million used to purchase our stock under our stock repurchase program;
- $2.9 million paid to the selling shareholders of the Target Companies and Campagne under earnout agreements;
- $8.8 million in dividends paid to stockholders;
- $3.0 million used to purchase fixed assets; and
- $2.7 million used to repay borrowings under our credit facility

Our principal source of liquidity is our operating cash flow, which depends on continued customer renewal of our maintenance and support agreements and market acceptance of our products and services. Based on current estimates of revenue and expenses, we believe that the currently available sources of funds and anticipated cash flows from operations will be adequate to finance our operations and anticipated capital expenditures for the foreseeable future and repay outstanding debt. Stock repurchases and 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 or pay further dividends and/or repurchase our common stock.

We have drawn on our credit facilities from time to time to help us meet other substantial short-term financial needs, such as business acquisitions and share repurchases. On July 25, 2007, we entered into a new five-year, $75.0 million credit facility to replace the existing three-year, $30.0 million credit facility that would have expired September 30, 2007; the new credit facility provides us with greater financial flexibility because of its size and more favorable terms compared with the previous facility. On June 23, 2008, we increased the credit facility by $15.0 million to an aggregate amount of $90.0 million. See Note 8 for more details of the terms of this credit facility.

Operating cash flow

Net cash provided by operating activities increased $2.1 million to $21.5 million in the six-month period ended June 30, 2008 compared to $19.4 million as reported for the six months ended June 30, 2007. Throughout both periods, our cash flows from operations were derived principally from: (i) our earnings from on-going operations prior to non-cash expenses such as depreciation, amortization and stock-based compensation and adjustments to our provision for sales returns and allowances; (ii) the tax benefit associated with our deferred tax asset, which reduces our cash outlay for income tax expense; and (iii) changes in our working capital.

Working capital changes that impact the statement of cash flows include accounts receivable, other current assets, accounts payable, accrued expenses and other liabilities and deferred revenue. Changes in accounts receivable and deferred revenue represent a decrease in operating cash flow of $7.7 million and $2.5 million in the six-month periods ended June 30, 2008 and 2007, respectively. This change is principally the result of a delay in customer billing that occurred during the second quarter of 2008 related to our conversion to a new accounting system in April. While customer billing is now current and consistent with our established practices, we billed approximately $15 million more in the month of June 2008 than in the same period last year and approximately 60% of the second quarters billings occurred in June compared to 37% in the prior year period. We expect to see larger than usual accounts receivable collections results in the third quarter of 2008 compared with what we have experienced in prior years third quarter; in fact, our collections on accounts receivable in July 2008 were $36.8 million compared with $28.7 million in July 2007.

Changes in our balances of accounts payable, accrued expenses and other liabilities and other current assets represent a decrease in operating cash flow of $1.3 million and $3.7 million in the six-month periods ended June 30, 2008 and 2007, respectively. Fluctuations in these changes affecting working capital accounts are primarily driven by the timing of vendor and tax payments and the timing of the receipt of customer payments.

Investing cash flow

Net cash used in the six-month period ended June 30, 2008 for investing activities was $5.9 million compared to $62.4 million of net cash used in investing activities during the six-month period ended June 30, 2007. The higher amount in

Blackbaud, Inc.

Item 2. Management s discussion and analysis of financial condition and results of operations (continued)

2007 is principally due to the acquisitions of the Target Companies on January 16, 2007. We invested $3.0 million in property and equipment in the first six months of 2008 compared to $3.1 million the first six months of 2007, an increase of $0.1 million.

Financing cash flow

Net cash used in financing activities for the six-month period ended June 30, 2008 was $20.3 million, comprised of $27.2 million provided by short-term borrowings and $0.4 million from the proceeds and excess tax benefits of stock option exercises offset by $36.0 million used for repurchases of our stock under our stock repurchase program, dividend payments of $8.8 million to stockholders, $2.7 million used to repay short-term borrowings and $0.3 million used to pay capital lease obligations. Comparatively, net cash used in financing activities for the six-month period ended June 30, 2007 was $7.2 million, comprised of $30.0 million provided by the issuance of debt in connection with the acquisition of the Target Companies and $1.5 million from the proceeds and excess tax benefits of stock option exercises, offset by $14.1 million used for repurchases of our stock, $15.0 million used to repay debt incurred in connection with the acquisition of the Target Companies, dividend payments of $7.5 million to stockholders, $0.2 million used to pay capital lease obligations and $1.9 million used to repay debt acquired in connection with the acquisitions of the Target Companies.

Commitments and contingencies

As of June 30, 2008, we had $24.5 million of outstanding debt and future minimum lease commitments of $18.8 million as follows (amounts in thousands):

					Payments due by period
		Less than			More than
	Total	1 year	1-3 years	3-5 years	5 years
Operating leases	$ 17,890	$ 3,812	$ 12,376	$ 1,497	$ 205
Capital leases	910	296	572	42	-
Short-term debt and interest	24,934	24,934	-	-	-
Total	$ 43,734	$ 29,042	$ 12,948	$ 1,539	$ 205

The commitments related to operating leases set forth above have not been reduced by the future minimum lease commitments under various sublease agreements extended through 2010.

We had $24.5 million of outstanding debt under our credit facility as of June 30, 2008. The amount in the table above of $24.9 million includes interest expense of $434,000, which assumes that $24.5 million that was outstanding as of June 30, 2008 will still be outstanding at the end of 2008. The actual interest expense recognized in our statements of operations will depend on the amount of debt and length of time the debt is outstanding, which could be different from our assumptions used in the table above.

In connection with the acquisition of eTapestry on August 1, 2007, discussed in Note 3 of the consolidated financial statements as of and for the six months ended June 30, 2008, we could pay up to a total of $1.5 million in contingent consideration based on the performance of eTapestry for the twelve-month periods ending September 30, 2008 and 2009.

As of June 30, 2008, we had accrued $0.3 million of state taxes and $0.2 million of interest and penalties related to uncertain tax positions taken in current and prior years. Please refer to Note 10 in our condensed notes to the consolidated financial statements for further information. We are unable to determine the period in which these liabilities will be settled, and accordingly, we have not included these amounts in the table above.

We utilize third-party relationships in conjunction with our products. The contractual arrangements vary in length from one to four years. In certain cases, these arrangements require a minimum annual purchase commitment. The total minimum purchase commitment under these arrangements at June 30, 2008 was approximately $0.6 million through 2010. We incurred expense under these arrangements of $0.2 million and $0.4 million for the six months periods ended June 30, 2008 and 2007, respectively.

Our Board of Directors approved an increase in our annual dividend from $0.34 to $0.40 per share in 2008 and declared a third quarter dividend of $0.10 per share payable on September 16, 2008 to stockholders of record on August 28, 2008.

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Item 2. Management s discussion and analysis of financial condition and results of operations (continued)

Dividends at this rate would total approximately $18.0 million in the aggregate on the common stock in 2008 (assuming 45,000,000 shares of common stock are outstanding). Our ability to pay dividends may be restricted by, among other things, the terms of our credit facility.

Foreign currency exchange rates

Approximately 14% of our total net revenue for the six-month period ended June 30, 2008 was derived from operations outside the United States. We do not have significant operations in countries in which the economy is considered to be highly inflationary. Our consolidated financial statements are denominated in U.S. dollars and, accordingly, changes in the exchange rate between foreign currencies and the U.S. dollar will affect the translation of our subsidiaries financial results into U.S. dollars for purposes of reporting our consolidated financial results. The accumulated currency translation adjustment, recorded as a separate component of stockholders equity, was $0.1 million at June 30, 2008 and at December 31, 2007.

The vast majority of our contracts are entered into by our U.S., Canadian or U.K. entities. The contracts entered into by the U.S. entity are almost always denominated in U.S. dollars, contracts entered into by our Canadian subsidiary are generally denominated in Canadian dollars, and contracts entered into by our U.K. subsidiary are generally denominated in pounds sterling. In recent years, the U.S. dollar has weakened against many non-U.S. currencies, including the British pound and Canadian dollar. During this period, our revenues generated in the United Kingdom have increased. Though we do not believe our increased exposure to currency exchange rates have had a material impact on our results of operations or financial position, we intend to continue to monitor such exposure and take action as appropriate.

Cautionary statement

We operate in a highly competitive environment that involves a number of risks, some of which are beyond our control. The following statement highlights some of these risks.

Statements contained in this Form 10-Q, which are not historical facts, are or might constitute forward-looking statements under the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Although we believe the expectations reflected in such forward-looking statements are based on reasonable assumptions, we can give no assurance that our expectations will be attained. Forward-looking statements involve known and unknown risks that could cause actual results to differ materially from expected results. Factors that could cause actual results to differ materially from our expectations expressed in the report include: general economic risks; uncertainty regarding increased business and renewals from existing customers; continued success in sales growth; management of integration of acquired companies and other risks associated with acquisitions; risks associated with successful implementation of multiple integrated software products; the ability to attract and retain key personnel; risks related to our dividend policy and share repurchase program, including potential limitations on our ability to grow and the possibility that we might discontinue payment of dividends; risks relating to restrictions imposed by the credit facility; risks associated with management of growth; lengthy sales and implementation cycles, particularly in larger organizations; technological changes that make our products and services less competitive;and the other risk factors set forth from time to time in our other SEC filings, including specifically our Annual Report on Form 10-K for the year ended December 31, 2007.

New accounting pronouncements

In June 2008, the FASB issued FASB Staff Position (FSP) No. EITF 03-6-1, Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities (FSP EITF 03-6-1), which clarifies that share-based payment awards that entitle their holders to receive nonforfeitable dividends before vesting should be considered participating securities. As participating securities, these instruments should be included in the calculation of basic EPS using the two-class method. Under FSP EITF 03-6-1, restricted stock granted by us is considered to be participating and would need to be included in the calculation of basic earnings per share at adoption. We are currently evaluating the impact that FSP EITF 03-6-1 will have on its financial statements. FSP EITF 03-6-1 will be effective for us on January 1, 2009.

In May 2008, the FASB issued SFAS No. 162, The Hierarchy of Generally Accepted Accounting Principles (SFAS No. 162). This standard is intended to improve financial reporting by identifying a consistent framework, or hierarchy, for selecting accounting principles to be used in preparing financial statements that are presented in conformity with generally accepted accounting principles in the United States for non-governmental entities. SFAS No. 162 will be effective 60 days following approval by the U.S. Securities and Exchange Commission of the Public Company

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Blackbaud, Inc.

Item 2. Management s discussion and analysis of financial condition and results of operations (continued)

Accounting Oversight Board s amendments to AU Section 411, The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles . We do not expect SFAS No. 162 to have a material impact on the preparation of our consolidated financial statements.

In April 2008, the FASB issued FSP FAS 142-3, Determination of the Useful Life of Intangible Assets (FSP FAS 142-3). FSP FAS 142-3 removes the requirement of SFAS No. 142, Goodwill and Other Intangible Assets (SFAS No. 142) for an entity to consider, when determining the useful life of an acquired intangible asset, whether the intangible asset can be renewed without substantial cost or material modifications to the existing terms and conditions associated with the intangible asset. FSP FAS 142-3 replaces the previous useful-life assessment criteria with a requirement that an entity consider its own experience in renewing similar arrangements. If the entity has no relevant experience, it would consider market participant assumptions regarding renewal. FSP FAS 142-3 will be effective for us on January 1, 2009. we are currently evaluating the potential impact of adopting FSP FAS 142-3.

In March 2008, the FASB issued SFAS No. 161, Disclosures about Derivative Instruments and Hedging Activities-an amendment of FASB Statement No. 133 (FAS No. 161). SFAS No. 161 is intended to improve financial standards for derivative instruments and hedging activities by requiring enhanced disclosures to enable investors to better understand their effects on an entity's financial position, financial performance, and cash flows. SFAS No. 161 requires enhanced disclosures of: (a) how and why an entity uses derivative instruments; (b) how derivative instruments and related hedged items are accounted for under FAS No. 133, Accounting for Derivative Instruments and Hedging Activities (FAS No. 133); and (c) its related interpretations and how derivative instruments and related hedged items affect an entity s financial position, financial performance and cash flows. SFAS No. 161 must be applied prospectively to all derivative instruments and non-derivative instruments that are designated and qualify as hedging instruments and related hedged items accounted for under FAS No. 133 for all financial statements issued for fiscal years and interim periods beginning after November 15, 2008, with early application encouraged. We are currently evaluating the impact that FAS No. 161 will have on our financial statements.

In December 2007, the FASB issued SFAS No. 141 (revised 2007), Business Combinations (SFAS No. 141R). SFAS No. 141R establishes principles and requirements for how an acquirer recognizes and measures in it s financial statements the identifiable assets acquired, the liabilities assumed, any noncontrolling interest in the acquiree and the goodwill acquired. SFAS No. 141R also establishes disclosure requirements to enable the evaluation of the nature and financial effects of the business combination. SFAS No. 141R will be effective for financial statements issued for fiscal years beginning after December 15, 2008. We are currently evaluating the potential impact of adoption of SFAS No. 141R on our consolidated financial statements.

In December 2007, the FASB issued SFAS No. 160 Noncontrolling Interests in Consolidated Financial Statements-an Amendment of ARB No. 51 (SFAS No. 160). SFAS No. 160 establishes accounting and reporting standards pertaining to ownership interests in subsidiaries held by parties other than the parent, the amount of net income attributable to the parent and to the noncontrolling interest, changes in a parent s ownership interest, and the valuation of any retained noncontrolling equity investment when a subsidiary is deconsolidated. This statement also establishes disclosure requirements that clearly identify and distinguish between the interests of the parent and the interests of the noncontrolling owners. SFAS No. 160 will be effective for fiscal years beginning on or after December 15, 2008. We are currently evaluating the potential impact of adoption of SFAS No. 160 on our consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements, (SFAS No. 157) which defines fair value, establishes guidelines for measuring fair value and expands disclosures regarding fair value measurements. SFAS No. 157 does not require any new fair value measurements but rather eliminates inconsistencies in guidance found in various prior accounting pronouncements. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007. However, on February 12, 2008, the FASB issued FASB Staff Position (FSP) SFAS No. 157-2 (FSP 157-2), which delays the effective date of SFAS No. 157 for all non-financial assets and non-financial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). FSP 157-2 partially defers the effective date of SFAS No. 157 to fiscal years beginning after November 15, 2008, and interim periods within those fiscal years for items within the scope of FSP 157-2. In addition, FASB issued a staff position, FSP SFAS No. 157-1, to clarify that SFAS No. 157 does not apply under SFAS No. 13, Accounting for Leases (SFAS No. 13), and other accounting pronouncements that address fair value measurements for purposes of lease classifications under SFAS No. 13. We adopted SFAS No. 157 on January 1, 2008, except as it applies to those non-financial assets and non-financial liabilities as noted in FSP 157-2. The major categories of assets and liabilities that are measured at fair value, for which we have not yet applied the provisions of SFAS No. 157 include goodwill and long-lived assets subject to impairment tests under SFAS No. 142 and SFAS No. 144. We do not expect the adoption of SFAS No. 157, as it relates to non-financial assets and non-financial liabilities as noted in

FSP 157-2, to have a material impact on our consolidated financial position, results of operations or cash flows.

Blackbaud, Inc.

Item 3. Quantitative and qualitative disclosures about market risk

Due to the nature of our short-term investments, our lack of material long-term debt and our ability to use currently available sources of funds and anticipated cash flows from operations to finance our operations and anticipated capital expenditures, we have concluded that we currently face no material interest risk exposure. Therefore, no quantitative tabular disclosures are required. For a discussion of our exposure to foreign currency fluctuations, see the Foreign currency exchange rates section on page 32.

Item 4. Controls and procedures

Evaluation of disclosure controls and procedures

Disclosure controls and procedures (as defined in Exchange Act Rule 13a-15(e)) are designed only to provide reasonable assurance that they will meet their objectives. As of the end of the period covered by this report, we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of our disclosure controls and procedures (as defined in Rule 13a-15(e)) pursuant to Exchange Act Rule 13a-15. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures are effective to provide the reasonable assurance discussed above.

Changes in internal control over financial reporting

During the second quarter of 2008, we implemented a new enterprise resource planning, or ERP, system. The new ERP system was designed and implemented, in part, to enhance the overall system of internal control over financial reporting through further automation and integration of business processes and was not implemented in response to any identified deficiency or material weakness in the Company s internal control over financial reporting. This implementation was significant in scale and complexity and significantly affected certain accounting functions. Both during and after the implementation, the Company maintained its internal control design by changing detailed key controls to achieve all key financial reporting assertions. As noted under Liquidity and capital resources in Part I Item 2 Management s discussion and analysis of financial condition and results of operations, the implementation did have an impact on accounts receivable and cash flow from operations that management believes was short term in nature. Other than the ERP implementation, during the quarter ended June 30, 2008, there were no changes in our internal controls over financial reporting that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Blackbaud, Inc.

PART II. OTHER INFORMATION

Item 2. Unregistered sales of equity securities and use of proceeds

On June 13, 2007, our Board of Directors approved a new stock repurchase program that authorizes us to repurchase an amount of our common stock up to $35.0 million plus the aggregate amount of $6,181,751 that was authorized but not used under the prior stock repurchase program as of that date and terminated the prior program. The new program has no expiration date. On May 7, 2008 our Board of Directors approved a new stock repurchase program that authorizes the Company to purchase up to $40.0 million of the Company s outstanding shares of common stock including the aggregate amount of $6,376,383 available but not yet used under the prior program as of that date and terminated the prior program.

Information about shares of common stock repurchased during the three months ended June 30, 2008 under our stock repurchase program, as well as common stock withheld by us to satisfy tax obligations of employees, appears in the table below.

Period	Total number of shares purchased (1)	Average price paid per share	Total number of shares purchased as part of publicly announced plans or programs	Approximate dollar value of shares that may yet be purchased under the plan or programs
Beginning balance, April 1, 2008				$ 18,274,474
April 1, 2008 through April 30, 2008	495,000	$ 23.01	495,000	$ 6,885,499
May 1, 2008 through May 31, 2008 (3)	84,406	$ 23.59	84,000	$ 38,500,289
June 1, 2008 through June 30, 2008	115	$ 23.57	-	$ 38,500,289
Total	579,521	$ 23.06	579,000	

(1) Includes 521 shares withheld by us to satisfy the tax obligations of employees due upon vesting of restricted stock during the period.

Item 4. Submission of matters to a vote of security holders

Our stockholders voted on two items at the 2008 Annual Meeting of Stockholders held on June 18, 2008:

1. The election of three Class A directors to terms ending in 2011;
2. Approval of the Blackbaud, Inc. 2008 Equity Incentive Plan; and
3. Ratification of PricewaterhouseCoopers LLP as our independent registered public accounting firm.

The nominees for directors were elected based upon the following votes:

Nominee	Votes for	Votes withheld
Timothy Chou	40,290,902	1,798,122
Marco W. Hellman	40,289,275	1,799,749
Carolyn Miles	41,899,308	189,716

George H. Ellis and Andrew M. Leitch continued their terms as Class B directors, with terms expiring in 2009, and Marc E. Chardon and John P. McConnell continued their terms as Class C directors, with terms expiring in 2010.

The Blackbaud, Inc. 2008 Equity Incentive Plan was approved as follows:

Votes For	Votes against	Abstentions
26,296,403	12,279,097	78,383

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Blackbaud, Inc.

PART II. OTHER INFORMATION

Ratification of PricewaterhouseCoopers LLP as our independent registered public accounting firm was approved as follows:

Votes For	Votes against	Abstentions
41,785,706	237,925	65,392

Item 6. Exhibits

Exhibits:

31.1 Certification by the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

31.2 Certification by the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

32.1 Certification by the Chief Executive Officer pursuant to 18 U.S.C. 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

32.2 Certification by the Chief Financial Officer pursuant to 18 U.S.C. 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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Blackbaud, Inc.

SIGNATURES

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

BLACKBAUD, INC.

Date: August 11, 2008

By: /s/ Marc E. Chardon
Marc E. Chardon
President and Chief Executive Officer

Date: August 11, 2008

By: /s/ Timothy V. Williams
Timothy V. Williams
Senior Vice President and Chief Financial Officer

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E="1"> 08/01/22 1,475 1,408,625

Park Aerospace Holdings Ltd. (Ireland),

Gtd. Notes, 144A

4.500 03/15/23 200 190,500

Gtd. Notes, 144A

5.250 08/15/22 1,300 1,282,125

Gtd. Notes, 144A

5.500 02/15/24 100 98,125

4,639,719

TOTAL CORPORATE BONDS
(cost $642,984,366)

636,155,083

Shares

COMMON STOCK   0.0%

Oil, Gas & Consumable Fuels

Frontera Energy Corp. (Colombia)*
(cost $43,940)

1,033	30,265

TOTAL LONG-TERM INVESTMENTS
(cost $689,831,049)

683,268,951

See Notes to Financial Statements.

Schedule of Investments (continued)

as of May 31, 2018

Description	Shares	Value
SHORT-TERM INVESTMENT 3.4%		
AFFILIATED MUTUAL FUND		
PGIM Core Ultra Short Bond Fund (cost $18,214,256)(w)	18,214,256	$ 18,214,256
TOTAL INVESTMENTS 129.5% (cost $708,045,305)		701,483,207
Liabilities in excess of other assets (29.5)%		(159,822,956)
NET ASSETS 100.0%		$ 541,660,251

The following abbreviations are used in the annual report:

144A Security was purchased pursuant to Rule 144A under the Securities Act of 1933 and may not be resold subject to that rule except to qualified institutional buyers. Unless otherwise noted, 144A securities are deemed to be liquid.

LIBOR London Interbank Offered Rate

MTN Medium Term Note

PIK Payment-in-Kind

REITs Real Estate Investment Trusts

* Non-income producing security.
\# Principal amount is shown in U.S. dollars unless otherwise stated.
^ Indicates a Level 3 security. The aggregate value of Level 3 securities is $1,429,305 and 0.3% of net assets.
(aa) Represents security, or a portion thereof, with aggregate value of $361,922,464 segregated as collateral for amount of $165,000,000 borrowed and outstanding as of May 31, 2018. Of such securities, securities in the amount of $4,297,840 have been loaned for which, the amount borrowed serves as collateral.
(c) Variable rate instrument. The interest rate shown reflects the rate in effect at May 31, 2018.
(d) Represents issuer in default on interest payments and/or principal repayment. Non-income producing security. Such securities may be post-maturity.
(w) PGIM Investments LLC, the manager of the Fund, also serves as manager of the PGIM Core Ultra Short Bond Fund.

Fair Value Measurements:

Various inputs are used in determining the value of the Fund s investments. These inputs are summarized in the three broad levels listed below.

Level 1 unadjusted quoted prices generally in active markets for identical securities.

Level 2 quoted prices for similar securities, interest rates and yield curves, prepayment speeds, foreign currency exchange rates and other observable inputs.

Level 3 unobservable inputs for securities valued in accordance with Board approved fair valuation procedures.

The following is a summary of the inputs used as of May 31, 2018 in valuing such portfolio securities:

	Level 1	Level 2	Level 3
Investments in Securities			
Bank Loans	$	$ 45,654,298	$ 1,429,305
Corporate Bonds		636,155,083	

See Notes to Financial Statements.

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	Level 1	Level 2	Level 3
Investments in Securities (continued)			
Common Stock	$ 30,265	$	$
Affiliated Mutual Fund	18,214,256		
Total	$ 18,244,521	$ 681,809,381	$ 1,429,305

During the period, there were no transfers between Level 1, Level 2 and Level 3 to report.

Industry Classification:

The industry classification of investments and liabilities in excess of other assets shown as a percentage of net assets as of May 31, 2018 were as follows (unaudited):

Media	19.9%
Telecommunications	10.0
Home Builders	8.5
Healthcare-Services	8.3
Software	7.9
Electric	6.6
Oil & Gas	6.4
Retail	6.3
Chemicals	5.6
Computers	5.4
Entertainment	4.0
Affiliated Mutual Fund	3.4
Aerospace/Defense	3.2
Mining	3.2
Commercial Services	2.9
Diversified Financial Services	2.8
Packaging & Containers	2.7
Lodging	2.3
Foods	2.2
Real Estate Investment Trusts (REITs)	2.1
Building Materials	1.6
Metal Fabricate/Hardware	1.3
Pipelines	1.3
Banks	1.0
Iron/Steel	1.0
Trucking & Leasing	0.9%
Real Estate	0.8
Textiles	0.8
Semiconductors	0.7
Healthcare-Products	0.7
Auto Parts & Equipment	0.7
Internet	0.6
Advertising	0.6
Environmental Control	0.5
Forest Products & Paper	0.5
Leisure Time	0.4
Transportation	0.4
Gas	0.4
Auto Manufacturers	0.3
Pharmaceuticals	0.3
Distribution/Wholesale	0.3
Engineering & Construction	0.3

Home Furnishings	0.2
Electronics	0.1
Miscellaneous Manufacturing	0.1
	129.5
Liabilities in excess of other assets	(29.5)
	100.0%

Effects of Derivative Instruments on the Financial Statements and Primary Underlying Risk Exposure:

The Fund invested in derivative instruments during the reporting period. The primary type of risk associated with these derivative instruments is foreign exchange contracts risk. The effect of such derivative instruments on the Fund s financial position and financial performance as reflected in the Statement of Assets and Liabilities and Statement of Operations is presented in the summary below.

The Fund did not hold any derivative instruments as of May 31, 2018, accordingly, no derivative positions were presented in the Statement of Assets and Liabilities.

See Notes to Financial Statements.

Schedule of Investments (continued)

as of May 31, 2018

The effects of derivative instruments on the Statement of Operations for the year ended May 31, 2018 are as follows:

Amount of Realized Gain (Loss) on Derivatives Recognized in Income	
Derivatives not accounted for as hedging instruments, carried at fair value	**Forward Currency Contracts**
Foreign exchange contracts	$ (304,794)

Change in Unrealized Appreciation (Depreciation) on Derivatives Recognized in Income	
Derivatives not accounted for as hedging instruments, carried at fair value	**Forward Currency Contracts**
Foreign exchange contracts	$ 115,632

For the year ended May 31, 2018, the Fund s average volume of derivative activities is as follows:

Forward Foreign Currency Exchange Contracts Purchased(1)	Forward Foreign Currency Exchange Contracts Sold(1)
$ 2,038,164	$ 3,102,964

(1) Value at Settlement Date.

<u>Financial Instruments/Transactions Summary of Offsetting and Netting Arrangements</u>:

The Fund entered into financial instruments/transactions during the reporting period that are either offset in accordance with current requirements or are subject to enforceable master netting arrangements or similar agreements that permit offsetting. The information about offsetting and related netting arrangements for financial instruments/transactions, where the legal right to set-off exists, is presented in the summary below.

<u>Offsetting of financial instrument/transaction assets and liabilities:</u>

Description	Gross Market Value of Recognized Assets/(Liabilities)	Collateral Pledged/(Received)(1)	Net Amount
Securities on Loan	$ 4,297,840	$ (4,297,840)	$

(1) Collateral amount disclosed by the Fund is limited to the market value of financial instruments/transactions.

See Notes to Financial Statements.

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Statement of Assets & Liabilities

as of May 31, 2018

Assets	
Investments at value, including securities on loan of $4,297,840:	
Unaffiliated investments (cost $689,831,049)	$ 683,268,951
Affiliated investments (cost $18,214,256)	18,214,256
Cash	24,297
Dividends and interest receivable	11,568,644
Receivable for investments sold	2,804,566
Prepaid expenses	1,146
Total Assets	715,881,860
Liabilities	
Loan payable	165,000,000
Payable for investments purchased	8,179,767
Management fee payable	480,322
Loan interest payable	395,846
Accrued expenses and other liabilities	72,169
Deferred directors fees	48,803
Dividends payable	44,702
Total Liabilities	174,221,609
Net Assets	$ 541,660,251
Net assets were comprised of:	
Common stock, at par	$ 33,257
Paid-in capital in excess of par	633,874,484
	633,907,741
Undistributed net investment income	648,719
Accumulated net realized loss on investment and foreign currency transactions	(86,334,111)
Net unrealized depreciation on investments and foreign currencies	(6,562,098)
Net assets, May 31, 2018	$ 541,660,251
Net asset value per share ($541,660,251 ÷ 33,256,724 shares of common stock issued and outstanding)	$ 16.29

See Notes to Financial Statements.

Statement of Operations

Year Ended May 31, 2018

Net Investment Income (Loss)	
Income	
Interest income	$ 39,746,713
Affiliated dividend income	237,198
Other income	39,157
Total income	40,023,068
Expenses	
Management fee	5,776,678
Loan interest and commitment expense	3,909,272
Custodian and accounting fees	178,459
Shareholders reports	73,881
Legal fees and expenses	48,819
Audit fee	43,718
Directors fees	34,886
Registration fees	34,167
Transfer agent s fees and expenses	20,945
Miscellaneous	18,840
Total expenses	10,139,665
Net investment income (loss)	29,883,403
Realized And Unrealized Gain (Loss) On Investment And Foreign Currency Transactions	
Net realized gain (loss) on:	
Investment transactions	(184,652)
Forward currency contract transactions	(304,794)
Foreign currency transactions	(696,237)
	(1,185,683)
Net change in unrealized appreciation (depreciation) on:	
Investments	(11,036,647)
Forward currency contracts	115,632
Foreign currencies	(18,976)
	(10,939,991)
Net gain (loss) on investment and foreign currency transactions	(12,125,674)
Net Increase (Decrease) In Net Assets Resulting From Operations	$ 17,757,729

See Notes to Financial Statements.

Statements of Changes in Net Assets

	Year Ended May 31, 2018	2017
Increase (Decrease) in Net Assets		
Operations		
Net investment income (loss)	$ 29,883,403	$ 32,671,530
Net realized gain (loss) on investment and foreign currency transactions	(1,185,683)	(425,244)
Net change in unrealized appreciation (depreciation) on investments and foreign currencies	(10,939,991)	11,073,826
Net increase (decrease) in net assets resulting from operations	17,757,729	43,320,112
Dividends from net investment income	(36,166,687)	(41,654,047)
Total increase (decrease)	(18,408,958)	1,666,065
Net Assets:		
Beginning of year	560,069,209	558,403,144
End of year(a)	$ 541,660,251	$ 560,069,209
(a) Includes undistributed/(distributions in excess of) net investment income of:	$ 648,719	$ 2,436,730

See Notes to Financial Statements.

Statement of Cash Flows

For Year Ended May 31, 2018

Increase (Decrease) in Cash	
Cash flows from operating activities:	
Interest and dividends received (excluding discount and premium amortization of $(4,384,560))	$ 44,289,365
Operating expenses paid	(6,243,892)
Loan interest paid	(3,819,012)
Purchases of long-term portfolio investments	(506,723,096)
Proceeds from disposition of long-term portfolio investments	530,749,384
Net purchases and sales of short-term investments	1,177,803
Increase in receivable for investments sold	(2,804,566)
Decrease in payable for investments purchased	(4,658,442)
Net cash paid from forward currency contract transactions	(304,794)
Net cash paid from foreign currency transactions	(696,237)
Decrease in prepaid expenses	108
Effect of exchange rate changes	(18,976)
Net cash provided from operating activities	50,947,645
Cash flows from financing activities:	
Cash dividends paid	(36,200,028)
Decrease in borrowing	(15,000,000)
Net cash used in financing activities	(51,200,028)
Net increase (decrease) in cash	(252,383)
Cash at beginning of year, including foreign currency	276,680
Cash at end of year, including foreign currency	$ 24,297
Reconciliation of Net Increase (Decrease) in Net Assets to Net Cash Provided from Operating Activities	
Net increase in net assets resulting from operations	17,757,729
Decrease in investments	29,588,651
Net realized loss on investment and foreign currency transactions	1,185,683
Decrease in net unrealized depreciation on investments and foreign currencies	10,939,991
Net cash paid from forward currency contract transactions	(304,794)
Net cash paid from foreign currency transactions	(696,237)
Effect of exchange rate changes	(18,976)
Increase in interest and dividends receivable	(118,263)
Increase in receivable for investments sold	(2,804,566)
Decrease in prepaid expenses	108
Decrease in payable for investments purchased	(4,658,442)
Decrease in loan interest payable	90,260
Increase in accrued expenses and other liabilities	(21,688)
Decrease in deferred directors fees	8,189
Total adjustments	33,189,916
Net cash provided from operating activities	$ 50,947,645

See Notes to Financial Statements.

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Notes to Financial Statements

PGIM Short Duration High Yield Fund, Inc. (formerly known as Prudential Short Duration High Yield Fund, Inc.) (the Fund) is registered under the Investment Company Act of 1940, as amended (1940 Act), as a diversified, closed-end management investment company. The Fund was incorporated as a Maryland corporation on November 14, 2011.

The investment objective of the Fund is to provide a high level of current income.

1. Accounting Policies

The Fund follows investment company accounting and reporting guidance of the Financial Accounting Standards Board (FASB) Accounting Standard Codification Topic 946 Financial Services *Investment Companies.* The following accounting policies conform to U.S. generally accepted accounting principles. The Fund consistently follows such policies in the preparation of its financial statements.

Securities Valuation: The Fund holds securities and other assets and liabilities that are fair valued at the close of each day (generally, 4:00 PM Eastern time) the New York Stock Exchange (NYSE) is open for trading. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants on the measurement date. The Board of Directors (the Board) has adopted valuation procedures for security valuation under which fair valuation responsibilities have been delegated to PGIM Investments LLC (PGIM Investments or the Manager). Pursuant to the Board s delegation of fair valuation of a Fund s securities to the Manager, a Valuation Committee is hereby established as two persons, being one or more officers of the Fund, including: the Fund s Treasurer (or the Treasurer s direct reports); and the Fund s Chief or Deputy Chief Compliance Officer (or Vice-President-level direct reports of the Chief or Deputy Chief Compliance Officer). Under the current valuation procedures, the Valuation Committee of the Board is responsible for supervising the valuation of portfolio securities and other assets and liabilities. The valuation procedures permit the Fund to utilize independent pricing vendor services, quotations from market makers, and alternative valuation methods when market quotations are either not readily available or not deemed representative of fair value. A record of the Valuation Committee s actions is subject to the Board s review, approval, and ratification at its next regularly scheduled quarterly meeting.

For the fiscal reporting period-end, securities and other assets and liabilities were fair valued at the close of the last U.S. business day. Trading in certain foreign securities may occur when the NYSE is closed (including weekends and holidays). Because such foreign securities trade in markets that are open on weekends and U.S. holidays, the values of some of the Fund s foreign investments may change on days when investors cannot purchase or redeem Fund shares.

Various inputs determine how the Fund s investments are valued, all of which are categorized according to the three broad levels (Level 1, 2, or 3) detailed in the Schedule of Investments.

Notes to Financial Statements (continued)

Investments in open-end, non-exchange-traded mutual funds are valued at their net asset values as of the close of the NYSE on the date of valuation. These securities are classified as Level 1 in the fair value hierarchy since they may be purchased or sold at their net asset values on the date of valuation.

Fixed income securities traded in the OTC market are generally classified as Level 2 in the fair value hierarchy. Such fixed income securities are typically valued using the market approach which generally involves obtaining data from an approved independent third-party vendor source. The Fund utilizes the market approach as the primary method to value securities when market prices of identical or comparable instruments are available. The third-party vendors valuation techniques used to derive the evaluated bid price are based on evaluating observable inputs, including but not limited to, yield curves, yield spreads, credit ratings, deal terms, tranche level attributes, default rates, cash flows, prepayment speeds, broker/dealer quotations and reported trades. Certain Level 3 securities are also valued using the market approach when obtaining a single broker quote or when utilizing transaction prices for identical securities that have been used in excess of five business days. During the reporting period, there were no changes to report with respect to the valuation approach and/or valuation techniques discussed above.

Bank loans are generally valued at prices provided by approved independent pricing vendors. The pricing vendors utilize broker/dealer quotations and provide prices based on the average of such quotations. Bank loans valued using such vendor prices are generally classified as Level 2 in the fair value hierarchy. Bank loans valued based on a single broker quote or at the original transaction price in excess of five business days are classified as Level 3 in the fair value hierarchy.

OTC derivative instruments are generally classified as Level 2 in the fair value hierarchy. Such derivative instruments are typically valued using the market approach and/or income approach which generally involves obtaining data from an approved independent third-party vendor source. The Fund utilizes the market approach when quoted prices in broker-dealer markets are available but also includes consideration of alternative valuation approaches, including the income approach. In the absence of reliable market quotations, the income approach is typically utilized for purposes of valuing OTC derivatives such as interest rate swaps based on a discounted cash flow analysis whereby the value of the instrument is equal to the present value of its future cash inflows or outflows. Such analysis includes projecting future cash flows and determining the discount rate (including the present value factors that affect the discount rate) used to discount the future cash flows. In addition, the third-party vendors valuation techniques used to derive the evaluated OTC derivative price is based on evaluating observable inputs, including but not limited to, underlying asset prices, indices, spreads, interest rates and exchange rates. Certain OTC derivatives may be classified as Level 3 when valued using the market approach by obtaining a single broker quote or when utilizing unobservable inputs in the income approach. During the reporting period, there were no changes to report with respect to the valuation approach and/or valuation techniques discussed above.

Securities and other assets that cannot be priced according to the methods described above are valued based on pricing methodologies approved by the Board. In the event that unobservable inputs are used when determining such valuations, the securities will be classified as Level 3 in the fair value hierarchy.

When determining the fair value of securities, some of the factors influencing the valuation include: the nature of any restrictions on disposition of the securities; assessment of the general liquidity of the securities; the issuer s financial condition and the markets in which it does business; the cost of the investment; the size of the holding and the capitalization of the issuer; the prices of any recent transactions or bids/offers for such securities or any comparable securities; any available analyst media or other reports or information deemed reliable by the Manager regarding the issuer or the markets or industry in which it operates. Using fair value to price securities may result in a value that is different from a security s most recent closing price and from the price used by other unaffiliated mutual funds to calculate their net asset values.

Restricted and Illiquid Securities: Subject to guidelines adopted by the Board, the Fund may invest without limit in illiquid securities, including those which are restricted as to disposition under securities law (restricted securities). Restricted securities are valued pursuant to the valuation procedures noted above. Illiquid securities are those that, because of the absence of a readily available market or due to legal or contractual restrictions on resale, cannot be sold within seven days in the ordinary course of business at approximately the amount at which the Fund has valued the investment. Therefore, the Fund may find it difficult to sell illiquid securities at the time considered most advantageous by its Subadviser and may incur transaction costs that would not be incurred in the sale of securities that were freely marketable. Certain securities that would otherwise be considered illiquid because of legal restrictions on resale to the general public may be traded among qualified institutional buyers under Rule 144A of the Securities Act of 1933. These Rule 144A securities, as well as commercial paper that is sold in private placements under Section 4(2) of the Securities Act, may be deemed liquid by the Fund s Subadviser under the guidelines adopted by the Board of the Fund. However, the liquidity of the Fund s investments in Rule 144A securities could be impaired if trading does not develop or declines.

Foreign Currency Translation: The books and records of the Fund are maintained in U.S. dollars. Foreign currency amounts are translated into U.S. dollars on the following basis:

(i) market value of investment securities, other assets and liabilities at the current rates of exchange;

(ii) purchases and sales of investment securities, income and expenses at the rates of exchange prevailing on the respective dates of such transactions.

Although the net assets of the Fund are presented at the foreign exchange rates and market values at the close of the period, the Fund does not generally isolate that portion of the results of operations arising as a result of changes in the foreign exchange rates from the fluctuations arising from changes in the market prices of long-term portfolio securities held at the end of the period. Similarly, the Fund does not isolate the effect of changes in foreign exchange rates from the fluctuations arising from changes in the market prices of long-term portfolio securities sold during the period. Accordingly, holding period realized foreign currency gains (losses) are included in the reported net realized gains (losses) on

Notes to Financial Statements (continued)

investment transactions. Notwithstanding the above, the Fund does isolate the effect of fluctuations in foreign currency exchange rates when determining the gain (loss) upon the sale or maturity of foreign currency denominated debt obligations; such amounts are included in net realized gains (losses) on foreign currency transactions.

Additionally, net realized gains (losses) on foreign currency transactions represent net foreign exchange gains (losses) from the disposition of holdings of foreign currencies, currency gains (losses) realized between the trade and settlement dates on securities transactions, and the difference between the amounts of interest, dividends and foreign withholding taxes recorded on the Fund s books and the U.S. dollar equivalent amounts actually received or paid. Net unrealized currency gains (losses) from valuing foreign currency denominated assets and liabilities (other than investments) at period end exchange rates are reflected as a component of net unrealized appreciation (depreciation) on foreign currencies.

Forward and Cross Currency Contracts: A forward currency contract is a commitment to purchase or sell a foreign currency at a future date at a negotiated forward rate. The Fund enters into forward currency contracts in order to hedge its exposure to changes in foreign currency exchange rates on its foreign portfolio holdings or specific receivables and payables denominated in a foreign currency and to gain exposure to certain currencies. The contracts are valued daily at current forward exchange rates and any unrealized gain (loss) is included in net unrealized appreciation (depreciation) on investments and foreign currencies. Gain (loss) is realized on the settlement date of the contract equal to the difference between the settlement value of the original and negotiated forward contracts. This gain (loss), if any, is included in net realized gain (loss) on forward and cross currency contract transactions. Risks may arise upon entering into these contracts from the potential inability of the counterparties to meet the terms of their contracts. Forward currency contracts involve risks from currency exchange rate and credit risk in excess of the amounts reflected on the Statement of Assets and Liabilities. The Fund s maximum risk of loss from counterparty credit risk is the net value of the cash flows to be received from the counterparty at the end of the contract s life. A cross currency contract is a forward contract where a specified amount of one foreign currency will be exchanged for a specified amount of another foreign currency.

Master Netting Arrangements: The Fund is subject to various Master Agreements, or netting arrangements, with select counterparties. These are agreements which a subadviser may have negotiated and entered into on behalf of the Fund. A master netting arrangement between the Fund and the counterparty permits the Fund to offset amounts payable by the Fund to the same counterparty against amounts to be received; and by the receipt of collateral from the counterparty by the Fund to cover the Fund s exposure to the counterparty. However, there is no assurance that such mitigating factors are easily enforceable. In addition to master netting arrangements, the right to set-off exists when all the conditions are met such that each of the parties owes the other determinable amounts, the reporting party has the right to set-off the amount owed with the amount owed by the other party, the reporting party intends to set-off and the right of set-off is enforceable by law.

During the reporting period, there was no intention to settle on a net basis and all amounts are presented on a gross basis on the Statement of Assets and Liabilities.

The Fund is a party to ISDA (International Swaps and Derivatives Association, Inc.) Master Agreements with certain counterparties that govern OTC derivative and foreign exchange contracts entered into from time to time. The Master Agreements may contain provisions regarding, among other things, the parties general obligations, representations, agreements, collateral requirements, events of default and early termination. With respect to certain counterparties, in accordance with the terms of the Master Agreements, collateral posted to the Fund is held in a segregated account by the Fund s custodian and with respect to those amounts which can be sold or re-pledged, is presented in the Schedule of Investments. Collateral pledged by the Fund is segregated by the Fund s custodian and identified in the Schedule of Investments. Collateral can be in the form of cash or debt securities issued by the U.S. Government or related agencies or other securities as agreed to by the Fund and the applicable counterparty. Collateral requirements are determined based on the Fund s net position with each counterparty. Termination events applicable to the Fund may occur upon a decline in the Fund s net assets below a specified threshold over a certain period of time. Termination events applicable to counterparties may occur upon a decline in the counterparty s long-term and short-term credit ratings below a specified level. In each case, upon occurrence, the other party may elect to terminate early and cause settlement of all derivative and foreign exchange contracts outstanding, including the payment of any losses and costs resulting from such early termination, as reasonably determined by the terminating party. Any decision by one or more of the Fund s counterparties to elect early termination could impact the Fund s future derivative activity.

Bank Loans: The Fund may invest in bank loans. Bank loans include fixed and floating rate loans that are privately negotiated between a corporate borrower and one or more financial institutions, including, but not limited to, term loans, revolvers, and other instruments issued in the bank loan market. The Fund may acquire interests in loans directly (by way of assignment from the selling institution) or indirectly (by way of the purchase of a participation interest from the selling institution). Under a bank loan assignment, the Fund generally will succeed to all the rights and obligations of an assigning lending institution and becomes a lender under the loan agreement with the relevant borrower in connection with that loan. Under a bank loan participation, the Fund generally will have a contractual relationship only with the lender, not with the relevant borrower. As a result, the Fund generally will have the right to receive payments of principal, interest, and any fees to which it is entitled only from the lender selling the participation and only upon receipt by the lender of the payments from the relevant borrower. The Fund may not directly benefit from the collateral supporting the debt obligation in which it has purchased the participation. As a result, the Fund will assume the credit risk of both the borrower and the institution selling the participation to the Fund.

Payment-In-Kind: The Fund may invest in the open market or receive pursuant to debt restructuring, securities that pay-in-kind (PIK) the interest due on such debt instruments. The PIK interest, computed at the contractual rate specified, is added to the existing principal balance of the debt when issued bonds have same terms as the bond or recorded as a separate bond when terms are different from the existing debt, and is recorded as interest income.

Notes to Financial Statements (continued)

Cash Flow Information: The Fund invests in securities and distributes dividends from net investment income, which are paid in cash or are reinvested at the discretion of stockholders. These activities are reported in the Statement of Changes in Net Assets and additional information on cash receipts and cash payments is presented in the Statement of Cash Flows.

Accounting practices that do not affect reporting activities on a cash basis include carrying investments at value, accruing income on PIK securities and accreting discounts and amortizing premiums on debt obligations.

Securities Transactions and Net Investment Income: Securities transactions are recorded on the trade date. Realized gains (losses) from investment and currency transactions are calculated on the specific identification method. Dividend income is recorded on the ex-date. Interest income, including amortization of premium and accretion of discount on debt securities, as required, is recorded on the accrual basis. Expenses are recorded on an accrual basis, which may require the use of certain estimates by management that may differ from actual.

Taxes: It is the Fund s policy to continue to meet the requirements of the Internal Revenue Code applicable to regulated investment companies and to distribute all of its taxable net income and capital gains, if any, to its stockholders. Therefore, no federal income tax provision is required. Withholding taxes on foreign dividends, interest and capital gains, if any, are recorded, net of reclaimable amounts, at the time the related income is earned. However, due to the timing of when distributions are made by the Fund, the Fund may be subject to an excise tax of 4% of the amount by which 98% of the Fund s annual taxable income for the calendar year and 98.2% of its net capital gains for a one-year period ending on October 31 exceed the distributions from such taxable income and net capital gains for the calendar year.

Dividends and Distributions: The Fund intends to make a level dividend distribution each month to the holders of Common Stock. The level dividend rate may be modified by the Board from time to time, and will be based upon the past and projected performance and expenses of the Fund. The Fund intends to also make a distribution during or with respect to each calendar year (which may be combined with a regular monthly distribution), which will generally include any net investment income and net realized capital gain for the year not otherwise distributed.

PGIM Investments has received an order from the Securities and Exchange Commission (the SEC) granting the Fund an exemption from Section 19(b) of the 1940 Act and Rule 19b-1 thereunder to permit certain closed-end funds managed by PGIM Investments to include realized long-term capital gains as a part of their respective regular distributions to the holders of Common Stock more frequently than would otherwise be permitted by the 1940 Act (generally once per taxable year). The Fund intends to rely on this exemptive order. The Board may, at the request of PGIM Investments, adopt a managed distribution policy.

Dividends and distributions to stockholders, which are determined in accordance with federal income tax regulations and which may differ from generally accepted accounting principles, are recorded on the ex-date. Permanent book/tax differences relating to income and gain (loss) are reclassified amongst undistributed net investment income, accumulated net realized gain (loss) and paid-in capital in excess of par, as appropriate.

Estimates: The preparation of financial statements requires management to make estimates and assumptions that affect the reported amounts and disclosures in the financial statements. Actual results could differ from those estimates.

2. Agreements

The Fund has a management agreement with PGIM Investments. Pursuant to this agreement, PGIM Investments has responsibility for all investment advisory services and supervises the subadviser s performance of such services. PGIM Investments has entered into a subadvisory agreement with PGIM, Inc., which provides subadvisory services to the Fund through its PGIM Fixed Income unit. The subadvisory agreement provides that PGIM, Inc. will furnish investment advisory services in connection with the management of the Fund. In connection therewith, PGIM, Inc. is obligated to keep certain books and records of the Fund. PGIM Investments pays for the services of PGIM, Inc., the cost of compensation of officers of the Fund, occupancy and certain clerical and bookkeeping costs of the Fund. The Fund bears all other cost and expenses.

The management fee paid to PGIM Investments is accrued daily and payable monthly, at an annual rate of 0.80% of the average daily value of the Fund s investable assets. Investable assets refers to the net assets attributable to the outstanding Common Stock of the Fund plus the liquidation preference of any outstanding preferred stock issued by the Fund, the principal amount of any borrowings and the principal on any debt securities issued by the Fund.

PGIM Investments and PGIM, Inc. are indirect, wholly-owned subsidiaries of Prudential Financial, Inc. (Prudential).

3. Other Transactions with Affiliates

The Fund may enter into certain securities purchase or sale transactions under Board approved Rule 17a-7 procedures. Rule 17a-7 is an exemptive rule under the 1940 Act, that permits purchase and sale transactions among affiliated investment companies, or between an investment company and a person that is affiliated solely by reason of having a common (or affiliated) investment adviser, common directors, and/or common officers. Such transactions are subject to ratification by the Board. For the reporting period ended May 31, 2018 no such transactions were entered into by the Fund.

The Fund may invest its overnight sweep cash in the PGIM Core Ultra Short Bond Fund (the Core Fund), a series of Prudential Investment Portfolios 2, registered under the 1940 Act and managed by PGIM Investments. Earnings from the Core Fund are disclosed on the Statement of Operations as Affiliated dividend income .

Notes to Financial Statements (continued)

4. Portfolio Securities

The aggregate cost of purchases and proceeds from sales of portfolio securities (excluding short-term investments and U.S. Government securities) for the year ended May 31, 2018, were $506,723,096 and $526,776,843, respectively.

A summary of cost of purchases and proceeds from sales of shares of affiliated mutual funds for the year ended May 31, 2018, is presented as follows:

Affiliated Mutual Funds*	Value, Beginning of Year	Cost of Purchases	Proceeds from Sales	Change in Unrealized Gain (Loss)	Realized Gain (Loss)	Value, End of Year	Shares, End of Year	Dividend Income
PGIM Core Ultra Short Bond Fund	$ 19,392,059	$ 331,180,239	$ 332,358,042	$	$	$ 18,214,256	18,214,256	$237,198

* The Fund did not have any capital gain distributions during the reporting period.

5. Distributions and Tax Information

Distributions to stockholders, which are determined in accordance with federal income tax regulations and which may differ from generally accepted accounting principles, are recorded on the ex-date. In order to present undistributed net investment income, accumulated net realized loss on investment and foreign currency transactions and paid-in capital in excess of par on the Statement of Assets and Liabilities that more closely represent their tax character, certain adjustments have been made to undistributed net investment income and accumulated net realized loss on investment and foreign currency transactions. For the year ended May 31, 2018, the adjustments were to increase undistributed net investment income and increase accumulated net realized loss on investment and foreign currency transactions by $4,495,273 due to differences in the treatment for book and tax purposes of premium amortization, certain transactions involving foreign securities, paydowns and other book to tax differences. Net investment income, net realized gain (loss) on investment and foreign currency transactions and net assets were not affected by this change.

For the years ended May 31, 2018 and May 31, 2017, the tax character of dividends paid by the Fund were $36,166,687 and $41,654,047 of ordinary income, respectively.

As of May 31, 2018, the accumulated undistributed earnings on a tax basis was $1,278,144 of ordinary income. This differs from the amount shown on the Statement of Assets and Liabilities primarily due to cumulative timing differences between financial and tax reporting.

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The United States federal income tax basis of the Fund s investments and the net unrealized depreciation as of May 31, 2018 were as follows:

Tax Basis	Gross Unrealized Appreciation	Gross Unrealized Depreciation	Net Unrealized Depreciation
$713,558,276	$4,175,591	$(16,250,660)	$(12,075,069)

The difference between book basis and tax basis was primarily attributable to deferred losses on wash sales, differences in the treatment of premium amortization for book and tax purposes and other book to tax differences.

For federal income tax purposes, the Fund had a capital loss carryforward as of May 31, 2018 of approximately $81,322,000 which can be carried forward for an unlimited period. No capital gains distributions are expected to be paid to shareholders until net gains have been realized in excess of such losses.

Management has analyzed the Fund s tax positions taken on federal, state and local income tax returns for all open tax years and has concluded that no provision for income tax is required in the Fund s financial statements for the current reporting period. The Fund s federal, state and local income and federal excise tax returns for tax years for which the applicable statutes of limitations have not expired are subject to examination by the Internal Revenue Service and state departments of revenue.

6. Capital and Ownership

There are 1 billion shares of $0.001 par value common stock authorized. Prior to commencement of operations on April 30, 2012, the Fund issued 5,240 shares of common stock to Prudential at an aggregate purchase price of $100,084. As of May 31, 2018, Prudential owned 8,583 shares of the Fund.

For the year ended May 31, 2018, the Fund did not issue any shares of Common Stock in connection with the Fund s dividend reinvestment plan.

7. Borrowings and Re-hypothecation

The Fund currently is a party to a committed credit facility (the credit facility) with a financial institution. The credit facility provides for a maximum commitment of $240 million. Interest on any borrowings under the credit facility is payable at the negotiated rates and a commitment. The Fund s obligations under the credit facility are secured by the assets of the Fund segregated for the purpose of securing the amount borrowed. The purpose of the credit facility is to provide the Fund with portfolio leverage and to meet its general cash flow requirements.

The Fund utilized the credit facility during the year ended May 31, 2018. The average daily outstanding loan balance for the 365 days that the Fund utilized the facility during the period was $171,191,781, borrowed at a weighted average interest rate of 2.25% and commitment fees. The maximum loan balance outstanding during the period was $180,000,000. At May 31, 2018, the Fund had an outstanding loan balance of

$165,000,000.

Notes to Financial Statements (continued)

Re-hypothecation: The credit facility agreement permits, subject to certain conditions, the financial institution to re-hypothecate, up to the amount outstanding under the facility, portfolio securities segregated by the Fund as collateral. The Fund continues to receive interest on re-hypothecated securities. The Fund also has the right under the agreement to recall the re-hypothecated securities from the financial institution on demand. If the financial institution fails to deliver the recalled security in a timely manner, the Fund will be compensated by the financial institution for any fees or losses related to the failed delivery or, in the event a recalled security will not be returned by the financial institution, the Fund, upon notice to the financial institution, may reduce the loan balance outstanding by the value of the recalled security failed to be returned plus accrued interest. The Fund will receive a portion of the fees earned by the financial institution in connection with the rehypothecation of portfolio securities. Such earnings are disclosed in the Statement of Operations under Other income.

8. Distributions

Dividends and Distributions: On May 31, 2018 the Fund declared monthly dividends of $0.0850 per share payable on June 29, 2018, July 31, 2018 and August 31, 2018, respectively, to shareholders of record on June 15, 2018, July 13, 2018 and August 17, 2018, respectively. The ex-dates are June 14, 2018 , July 12, 2018 and August 16, 2018, respectively.

9. Other Risks

The Fund s risks include, but are not limited to, the following:

Bond Obligations Risk: The Fund s holdings, share price, yield and total return may fluctuate in response to bond market movements. The value of bonds may decline for issuer-related reasons, including management performance, financial leverage and reduced demand for the issuer s goods and services. Certain types of fixed-income obligations also may be subject to call and redemption risk, which is the risk that the issuer may call a bond held by the Fund for redemption before it matures and the Fund may not be able to reinvest at the same level and therefore would earn less income.

Derivatives Risk: Derivatives involve special risks and costs and may result in losses to the Fund. The prices of derivatives may move in unexpected ways, especially in abnormal market conditions. Some derivatives are leveraged and therefore may magnify or otherwise increase investment losses to the Fund. The Fund s use of derivatives may also increase the amount of taxes payable by shareholders. Other risks arise from the potential inability to terminate or close out of derivatives positions. A liquid secondary market may not always exist for the Fund s derivatives positions. Generally, many over-the-counter derivative instruments will not have liquidity beyond the counterparty to the instrument. Over-the-counter derivative instruments also involve the risk that the other party will not meet its obligations to the Fund.

Emerging Markets Risk: The risks of foreign investments are greater for investments in or exposed to emerging markets. Emerging market countries typically have economic and political systems that are less fully developed, and can be expected to be less stable, than those of more developed countries. For example, the economies of such countries can be subject to rapid and unpredictable rates of inflation or deflation. Low trading volumes may result in a lack of liquidity and price volatility. Emerging market countries may have policies that restrict investment by non-US investors, or that prevent non-US investors from withdrawing their money at will.

Foreign Securities Risk: The Fund s investments in securities of foreign issuers or issuers with significant exposure to foreign markets involve additional risk. Foreign countries in which the Fund may invest may have markets that are less liquid, less regulated and more volatile than US markets. The value of the Fund s investments may decline because of factors affecting the particular issuer as well as foreign markets and issuers generally, such as unfavorable government actions, and political or financial instability.

Interest Rate Risk: The market price of the Fund s investments will change in response to changes in interest rates and other factors. During periods of rising interest rates, the market price of fixed income instruments generally declines. As interest rates increase, slower than expected principal payments may extend the average life of securities, potentially locking in below-market interest rates and reducing the Fund s value. In typical market interest rate environments, the prices of long-term debt obligations generally fluctuate more than prices of short-term debt obligations as interest rates change. Fluctuations in the market price of the Fund s instruments will not affect interest income derived from instruments already owned by the Fund, but will be reflected in the Fund s NAV.

Leverage Risk: The Fund may seek to enhance the level of its current distributions to holders of common stock through the use of leverage. The Fund may use leverage through borrowings, including loans from certain financial institutions. The Fund may borrow in amounts up to 331/3% (as determined immediately after borrowing) of the Fund s investable assets. The use of leverage can create special risks. There can be no assurance that any leveraging strategy the Fund employs will be successful during any period in which it is employed.

Liquidity Risk: The Fund may invest in instruments that trade in lower volumes and are less liquid than other investments. Liquidity risk includes the risk that the Fund may make investments that may become less liquid in response to market developments or adverse investor perceptions. Investments that are illiquid or that trade in lower volumes may be more difficult to value. When there is no willing buyer and investments cannot be readily sold at the desired time or price, the Fund may have to accept a lower price or may not be able to sell the instrument at all. An inability to sell a portfolio position can adversely affect the Fund s value or prevent the Fund from being able to take advantage of other investment opportunities.

Notes to Financial Statements (continued)

Market and Credit Risk: Securities markets may be volatile and the market prices of the Fund s securities may decline. Securities fluctuate in price based on changes in an issuer s financial condition and overall market and economic conditions. If the market prices of the securities owned by the Fund fall, the value of an investment in the Fund will decline. Additionally, the Fund may also be exposed to credit risk in the event that an issuer or guarantor fails to perform or that an institution or entity with which the Fund has unsettled or open transactions defaults.

Risks of Investments in Bank Loans: The Fund s ability to receive payments of principal and interest and other amounts in connection with loans (whether through participations, assignments or otherwise) will depend primarily on the financial condition of the borrower. The failure by the Fund to receive scheduled interest or principal payments on a loan because of a default, bankruptcy or any other reason would adversely affect the income of the Fund and would likely reduce the value of its assets. Even with loans secured by collateral, there is the risk that the value of the collateral may decline, may be insufficient to meet the obligations of the borrower, or be difficult to liquidate. In the event of a default, the Fund may have difficulty collecting on any collateral and would not have the ability to collect on any collateral for an uncollateralized loan. Further, the Fund s access to collateral, if any, may be limited by bankruptcy laws.

Financial Highlights

	Year Ended May 31,				
	2018	2017	2016	2015	2014
Per Share Operating Performance(a):					
Net Asset Value, Beginning of Year	$16.84	$16.79	$17.84	$18.82	$19.18
Income (loss) from investment operations:					
Net investment income (loss)	0.90	0.98	1.06	1.20	1.22
Net realized and unrealized gain (loss) on investment and foreign currency transactions	(0.36)	0.32	(0.75)	(0.59)	0.02
Total from investment operations	0.54	1.30	0.31	0.61	1.24
Less Dividends:					
Dividends from net investment income	(1.09)	(1.25)	(1.36)	(1.59)	(1.60)
Net asset value, end of year	$16.29	$16.84	$16.79	$17.84	$18.82
Market price, end of year	$14.07	$15.59	$15.58	$15.75	$17.84
Total Return(b):	(2.89)%	8.36%	8.23%	(2.92)%	0.24%
Ratios/Supplemental Data:					
Net assets, end of year (000)	$541,660	$560,069	$558,403	$593,165	$626,021
Average net assets (000)	$550,742	$559,484	$560,771	$602,489	$630,017
Ratios to average net assets(c):					
Expenses after waivers and/or expense reimbursement(d)	1.84%	1.71%	1.55%	1.58%	1.52%
Expenses before waivers and/or expense reimbursement(d)	1.84%	1.71%	1.55%	1.58%	1.52%
Net investment income (loss)	5.43%	5.84%	6.29%	6.60%	6.45%
Portfolio turnover rate	72%	65%	58%	58%	75%
Asset coverage	428%	411%	372%	439%	363%
Total debt outstanding at period-end (000)	$165,000	$180,000	$205,000	$175,000	$238,000

(a) Calculated based on average shares outstanding during the year.
(b) Total return is calculated assuming a purchase of common stock at the current market price on the first day and a sale at the closing market price on the last day for the year reported. Dividends are assumed, for the purpose of this calculation, to be reinvested at prices obtainable under the Fund s dividend reinvestment plan. This amount does not reflect brokerage commissions or sales load.
(c) Does not include expenses of the underlying fund in which the Fund invests.
(d) Includes interest expense of 0.71%, 0.54%, 0.40%, 0.41% and 0.36%, for the years ended May 31, 2018, 2017, 2016, 2015 and 2014, respectively.

See Notes to Financial Statements.

Report of Independent Registered Public Accounting Firm

The Board of Directors and Shareholders

PGIM Short Duration High Yield Fund, Inc.:

Opinion on the Financial Statements

We have audited the accompanying statement of assets and liabilities of PGIM Short Duration High Yield Fund, Inc. (formerly Prudential Short Duration High Yield Fund, Inc.) (the Fund), including the schedule of investments, as of May 31, 2018, the related statements of operations and cash flows for the year then ended, the statements of changes in net assets for each of the years in the two-year period then ended, and the related notes (collectively, the financial statements) and the financial highlights for each of the years in the five-year period then ended. In our opinion, the financial statements and financial highlights referred to above present fairly, in all material respects, the financial position of the Fund as of May 31, 2018, the results of its operations and cash flows for the year then ended, the changes in its net assets for each of the years in the two-year period then ended, and the financial highlights for each of the years in the five-year period then ended, in conformity with U.S. generally accepted accounting principles.

Basis for Opinion

These financial statements and financial highlights are the responsibility of the Fund s management. Our responsibility is to express an opinion on these financial statements and financial highlights based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) (PCAOB) and are required to be independent with respect to the Fund in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements and financial highlights are free of material misstatement, whether due to error or fraud. Our audits included performing procedures to assess the risks of material misstatement of the financial statements and financial highlights, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements and financial highlights. Such procedures also included confirmation of securities owned as of May 31, 2018, by correspondence with the custodian, transfer agent and brokers or by other appropriate auditing procedures when replies from brokers were not received. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements and financial highlights. We believe that our audits provide a reasonable basis for our opinion.

We have served as the auditor of one or more PGIM and/or Prudential Retail investment companies since 2003.

July 18, 2018

New York, New York

Tax Information (unaudited)

For the year ended May 31, 2018, the Fund reports the maximum amount allowable but not less than 93.37% as interest related dividends in accordance with Section 871(k)(1) and 881(e)(1) of the Internal Revenue Code.

In January 2019, you will be advised on IRS Form 1099-DIV or substitute 1099-DIV as to the federal tax status of distributions received by you in calendar year 2018.

Other Information (unaudited)

Dividend Reinvestment Plan. Unless a holder of common stock elects to receive cash by contacting Computershare Trust Company, N.A. (the Plan Administrator), all dividends declared on common stock will be automatically reinvested by the Plan Administrator pursuant to the Fund s Automatic Dividend Reinvestment Plan (the Plan), in additional common stock. The holders of common stock who elect not to participate in the Plan will receive all dividends and other distributions (together, a Dividend) in cash paid by check mailed directly to the stockholder of record (or, if the common stock is held in street or other nominee name, then to such nominee) by the Plan Administrator as dividend disbursing agent. Participation in the Plan is completely voluntary and may be terminated or resumed at any time without penalty by notice if received and processed by the Plan Administrator prior to the Dividend record date; otherwise such termination or resumption will be effective with respect to any subsequently declared Dividend. Such notice will be effective with respect to a particular Dividend. Some brokers may automatically elect to receive cash on behalf of the holders of common stock and may re-invest that cash in additional common stock.

The Plan Administrator will open an account for each common stockholder under the Plan in the same name in which such common stockholder s common stock is registered. Whenever the Fund declares a Dividend payable in cash, non-participants in the Plan will receive cash and participants in the Plan will receive the equivalent in common stock. The common stock will be acquired by the Plan Administrator for the participants accounts, depending upon the circumstances described below, either (i) through receipt of additional unissued but authorized common stock from the Fund (Newly Issued common stock) or (ii) by purchase of outstanding common stock on the open market (Open-Market Purchases) on the NYSE or elsewhere. If, on the payment date for any Dividend, the closing market price of the common stock plus per share fees (as defined below) is equal to or greater than the NAV per share of common stock (such condition being referred to as market premium), the Plan Administrator will invest the Dividend amount in Newly Issued common stock on behalf of the participants. The number of Newly Issued common stock to be credited to each participant s account will be determined by dividing the dollar amount of the Dividend by the NAV per share of common stock on the payment date, provided that, if the NAV per share of common stock is less than or equal to 95% of the closing market price per share of common stock on the payment date, the dollar amount of the Dividend will be divided by 95% of the closing market price per common stock on the payment date. If, on the payment date for any Dividend, the NAV per share of common stock is greater than the closing market value per share of common stock plus per share fees (such condition being referred to as market discount), the Plan Administrator will invest the Dividend amount in shares of common stock acquired on behalf of the participants in Open-Market Purchases. Per share fees include any applicable brokerage commissions the Plan Administrator is required to pay.

In the event of a market discount on the payment date for any Dividend, the Plan Administrator will have until the last business day before the next date on which the common stock trades on an ex-dividend basis or 30 days after the payment date for such Dividend, whichever is sooner (the Last Purchase Date), to invest the Dividend amount in common stock acquired in Open-Market Purchases on behalf of participants. If, before the Plan Administrator has completed its Open-Market Purchases, the market price per share of common stock exceeds the NAV per share of common stock, the average per share purchase price paid by the Plan Administrator for common stock may exceed the NAV per share of the common stock, resulting in the acquisition of fewer shares of common stock than if the Dividend had been paid in Newly Issued common stock on the Dividend payment date. Because of the foregoing difficulty with respect to Open-Market Purchases, the Plan provides that if the Plan Administrator is unable to invest the full Dividend amount in Open-Market Purchases during the purchase period or if the market discount shifts to a market premium during the purchase period, the Plan Administrator may cease making Open-Market Purchases and may invest the uninvested portion of the Dividend amount in Newly Issued common stock at the NAV per share of common stock at the close of business on the Last Purchase Date, provided that, if the NAV is less than or equal to 95% of the then current market price per share of common stock, the dollar amount of the Dividend will be divided by 95% of the market price on the payment date for purposes of determining the number of shares issuable under the Plan.

The Plan Administrator maintains all stockholder accounts in the Plan and furnishes written confirmation of all transactions in the accounts, including information needed by stockholders for tax records. common stock in the account of each Plan participant will be held by the Plan Administrator on behalf of the Plan participant, and each stockholder proxy will include those shares purchased or received pursuant to the Plan. The Plan Administrator will forward all proxy solicitation materials to participants and vote proxies for shares held under the Plan in accordance with the instructions of the participants.

In the case of the holders of common stock such as banks, brokers or nominees that hold shares of common stock for others who are the beneficial owners, the Plan Administrator will administer the Plan on the basis of the number of shares of common stock certified from time to time by the record stockholder s name and held for the account of beneficial owners who participate in the Plan.

The Plan Administrator s service fee, if any, and expenses for administering the plan will be paid for by the Fund. If a participant elects by written, Internet or telephonic notice to the Plan Administrator to have the Plan Administrator sell part or all of the shares held by the Plan Administrator in the participant s account and remit the proceeds to the participant, the Plan Administrator is authorized to deduct a $15.00 transaction fee plus a $0.12 per share

Other Information (unaudited) (continued)

fee. If a participant elects to sell his or her shares of common stock, the Plan Administrator will process all sale instructions received no later than five business days after the date on which the order is received by the Plan Administrator, assuming the relevant markets are open and sufficient market liquidity exists (and except where deferral is required under applicable federal or state laws or regulations). Such sale will be made through the Plan Administrator s broker on the relevant market and the sale price will not be determined until such time as the broker completes the sale. In every case the price to the participant shall be the weighted average sale price obtained by the Plan Administrator s broker net of fees for each aggregate order placed by the participant and executed by the broker. To maximize cost savings, the Plan Administrator will seek to sell shares in round lot transactions. For this purpose the Plan Administrator may combine a participant s shares with those of other selling participants.

There will be no brokerage charges with respect to shares of common stock issued directly by the Fund. However, each participant will pay a pro rata share of brokerage commissions incurred in connection with Open-Market Purchases. Each participant will be charged a per share fee (currently $0.05 per share) on all Open-Market Purchases. The automatic reinvestment of Dividends will not relieve participants of any federal, state or local income tax that may be payable (or required to be withheld) on such Dividends. See Tax Matters. Participants that request a sale of common stock through the Plan Administrator are subject to brokerage commissions.

Each participant may terminate the participant s account under the Plan by so notifying the Plan Administrator via the Plan Administrator s website at www.computershare.com/investor, by filling out the transaction request form located at the bottom of the participant s Statement and sending it to the Plan Administrator or by calling the Plan Administrator. Such termination will be effective immediately if the participant s notice is received by the Plan Administrator prior to any dividend or distribution record date. Upon any withdrawal or termination, the Plan Administrator will cause to be delivered to each terminating participant a statement of holdings for the appropriate number of the Fund s whole book-entry shares of common stock and a check for the cash adjustment of any fractional share at the market value of the Fund s shares of common stock as of the close of business on the date the termination is effective less any applicable fees. In the event a participant s notice of termination is on or after a record date (but before payment date) for an account whose dividends are reinvested, the Plan Administrator, in its sole discretion, may either distribute such dividends in cash or reinvest them in shares of common stock on behalf of the terminating participant. In the event reinvestment is made, the Plan Administrator will process the termination as soon as practicable, but in no event later than five business days after the reinvestment is completed. The Plan may be terminated by the Fund upon notice in writing mailed to each participant at least 30 days prior to any record date for the payment of any dividend or distribution by the Fund.

The Fund reserves the right to amend or terminate the Plan. There is no direct service charge to participants with regard to purchases in the Plan; however, the Fund reserves the right to amend the Plan to include a service charge payable by the participants.

All correspondence or questions concerning the Plan should be directed to the Plan Administrator, Computershare Trust Company, N.A., P.O. Box 43078, Providence, RI 02940-3078 or by calling (toll free) 800-451-6788.

Supplemental Proxy Information (unaudited)

An Annual Meeting of Stockholders was held on March 9, 2018. At such meeting the stockholders elected the following Class III Directors:

Approval of Directors

Class III	**Affirmative Votes Cast**	**Shares Against/Withheld**
Scott E. Benjamin	25,628,362.000	384,984.000
Linda W. Bynoe	25,519,187.300	448,283.000
Laurie Simon Hodrick	25,548,129.300	419,341.000
Michael S. Hyland, CFA	25,474,931.300	452,539.000

Management of the Fund (unaudited)

Information about the Directors and Officers of the Fund is set forth below. Directors who are not deemed to be interested persons of the Fund, as defined in the Investment Company Act of 1940 (the 1940 Act), are referred to as Independent Directors. Directors who are deemed to be interested persons of the Fund are referred to as Interested Directors. The Directors are responsible for the overall supervision of the operations of the Fund and perform the various duties imposed on the directors of investment companies by the 1940 Act. The Board in turn elects the Officers, who are responsible for administering the day-to-day operations of the Fund.

Independent Directors

Name, Address, Age Position(s) Portfolios Overseen	**Principal Occupation(s) During Past Five Years**	**Term of Office & Length of Time Served**	**Other Directorships Held**
Ellen S. Alberding (60) Director Portfolios Overseen: 91	President and Board Member, The Joyce Foundation (charitable foundation) (since 2002); Vice Chair, City Colleges of Chicago (community college system) (since 2011); Trustee, Skills for America s Future (national initiative to connect employers to community colleges) (since 2011); Trustee, National Park Foundation (charitable foundation for national park system) (since 2009); Trustee, Economic Club of Chicago (since 2009).	Since 2013 (Class I)	None.
Kevin J. Bannon (65) Director Portfolios Overseen: 91	Managing Director (April 2008-May 2015) and Chief Investment Officer (October 2008-November 2013) of Highmount Capital LLC (registered investment adviser); formerly Executive Vice President and Chief Investment Officer (April 1993-August 2007) of Bank of New York Company; President (May 2003-May 2007) of BNY Hamilton Family of Mutual Funds.	Since 2011 (Class II)	Director of Urstadt Biddle Properties (since September 2008).
Linda W. Bynoe (65) Director Portfolios Overseen: 91	President and Chief Executive Officer (since March 1995) and formerly Chief Operating Officer (December 1989-February 1995) of Telemat Ltd. (management consulting); formerly Vice President (January 1985-June 1989) at Morgan Stanley & Co. (broker-dealer).	Since 2011 (Class III)	Director of Anixter International, Inc. (communication products distributor) (since January 2006); Director of Northern Trust Corporation (financial services) (since April 2006); Trustee of Equity Residential (residential real estate) (since December 2009).

Management of the Fund (unaudited) (continued)

Independent Directors			
Name, Address, Age Position(s) Portfolios Overseen	**Principal Occupation(s) During Past Five Years**	**Term of Office & Length of Time Served**	**Other Directorships Held**
Barry H. Evans (57) Director Portfolios Overseen: 90	Retired; formerly President (2005-2016), Global Chief Operating Officer (2014-2016), Chief Investment Officer Global Head of Fixed Income (1998-2014), and various portfolio manager roles (1986-2006), Manulife Asset Management U.S.	Since 2017 (Class I)	Director, Manulife Trust Company (since 2011); formerly Director, Manulife Asset Management Limited (2015-2017); formerly Chairman of the Board of Directors of Manulife Asset Management U.S. (2005-2016); formerly Chairman of the Board, Declaration Investment Management and Research (2008-2016).
Keith F. Hartstein (61) Director & Independent Chair Portfolios Overseen: 91	Retired; Member (since November 2014) of the Governing Council of the Independent Directors Council (organization of independent mutual fund directors); formerly President and Chief Executive Officer (2005-2012), Senior Vice President (2004-2005), Senior Vice President of Sales and Marketing (1997-2004), and various executive management positions (1990-1997), John Hancock Funds, LLC (asset management); Chairman, Investment Company Institute s Sales Force Marketing Committee (2003-2008).	Since 2013 (Class II)	None.
Laurie Simon Hodrick (55) Director Portfolios Overseen: 90	A. Barton Hepburn Professor Emerita of Economics in the Faculty of Business, Columbia Business School (since 2018); Visiting Professor of Law, Stanford Law School (since 2015); Visiting Fellow at the Hoover Institution, Stanford University (since 2015); Sole Member, ReidCourt LLC (since 2008) (a consulting firm); formerly A. Barton Hepburn Professor of Economics in the Faculty of Business, Columbia Business School (1996-2017); formerly Managing Director, Global Head of Alternative Investment Strategies, Deutsche Bank (2006-2008).	Since 2017 (Class III)	Independent Director, Corporate Capital Trust (since April 2017) (a business development company).

Visit our website at pgiminvestments.com

Independent Directors			
Name, Address, Age Position(s) Portfolios Overseen	**Principal Occupation(s) During Past Five Years**	**Term of Office & Length of Time Served**	**Other Directorships Held**
Michael S. Hyland, CFA (72) Director Portfolios Overseen: 90	Retired (since February 2005); formerly Senior Managing Director (July 2001-February 2005) of Bear Stearns & Co, Inc.; Global Partner, INVESCO (1999-2001); Managing Director and President of Salomon Brothers Asset Management (1989-1999).	Since 2011 (Class III)	None.
Richard A. Redeker (74) Director Portfolios Overseen: 91	Retired Mutual Fund Senior Executive (50 years); Management Consultant; Director, Mutual Fund Directors Forum (since 2014); Independent Directors Council (organization of independent mutual fund directors) Executive Committee, Chair of Policy Steering Committee, Governing Council.	Since 2011 (Class I)	None.
Brian K. Reid (56) Board Member Portfolios Overseen: 90	Retired; formerly Chief Economist for the Investment Company Institute (ICI) (2005-2017); formerly Senior Economist and Director of Industry and Financial Analysis at the ICI (1998-2004); formerly Senior Economist, Industry and Financial Analysis at the ICI (1996-1998); formerly Staff Economist at the Federal Reserve Board (1989-1996); Director, ICI Mutual Insurance Company (2012-2017).	Since 2018 (Class I)	None

Management of the Fund (unaudited) (continued)

Interested Directors			
Name, Address, Age **Position(s) Portfolios** **Overseen**	**Principal Occupation(s) During Past Five Years**	**Term of** **Office &** **Length of** **Time Served**	**Other Directorships Held**
Stuart S. Parker (55) Director & President Portfolios Overseen: 91	President of PGIM Investments LLC (since January 2012); Executive Vice President of Prudential Investment Management Services LLC (since December 2012); Executive Vice President of Jennison Associates LLC and Head of Retail Distribution of PGIM Investments LLC (June 2005-December 2011).	Since 2015 (Class I)	None.
Scott E. Benjamin (45) Director & Vice President Portfolios Overseen: 91	Executive Vice President (since June 2009) of PGIM Investments LLC; Executive Vice President (June 2009-June 2012) and Vice President (since June 2012) of Prudential Investment Management Services LLC; Executive Vice President (since September 2009) of AST Investment Services, Inc.; Senior Vice President of Product Development and Marketing, PGIM Investments (since February 2006); Vice President of Product Development and Product Management, PGIM Investments (2003-2006).	Since 2011 (Class III)	None.
Grace C. Torres (58)* Director Portfolios Overseen: 90	Retired; formerly Treasurer and Principal Financial and Accounting Officer of the PGIM Funds, Target Funds, Advanced Series Trust, Prudential Variable Contract Accounts and The Prudential Series Fund (1998-June 2014); Assistant Treasurer (March 1999-June 2014) and Senior Vice President (September 1999-June 2014) of PGIM Investments LLC; Assistant Treasurer (May 2003-June 2014) and Vice President (June 2005-June 2014) of AST Investment Services, Inc.; Senior Vice President and Assistant Treasurer (May 2003-June 2014) of Prudential Annuities Advisory Services, Inc.	Since 2015 (Class II)	Director (July 2015-January 2018) of Sun Bancorp, Inc. N.A. and Sun National Bank; Director (since January 2018) of OceanFirst Financial Corp. and OceanFirst Bank.

* Note: Prior to her retirement in 2014, Ms. Torres was employed by PGIM Investments LLC. Due to her prior employment, she is considered to be an interested person under the 1940 Act. Ms. Torres is a Non-Management Interested Director.

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Fund Officers[a]		
Name, Address and Age Position with Fund	**Term of Office**	**Principal Occupation(s) During Past Five Years**
Raymond A. O Hara (62) Chief Legal Officer	Since 2012	Vice President and Corporate Counsel (since July 2010) of Prudential Insurance Company of America (Prudential); Vice President (March 2011-Present) of Pruco Life Insurance Company and Pruco Life Insurance Company of New Jersey; Vice President and Corporate Counsel (March 2011-Present) of Prudential Annuities Life Assurance Corporation; Chief Legal Officer of PGIM Investments LLC (since June 2012); Chief Legal Officer of PMFS (since June 2012) and Corporate Counsel of AST Investment Services, Inc. (since June 2012); formerly Assistant Vice President and Corporate Counsel (September 2008-July 2010) of The Hartford Financial Services Group, Inc.; formerly Associate (September 1980-December 1987) and Partner (January 1988-August 2008) of Blazzard & Hasenauer, P.C. (formerly, Blazzard, Grodd & Hasenauer, P.C.).
Chad A. Earnst (42) Chief Compliance Officer	Since 2014	Chief Compliance Officer (September 2014-Present) of PGIM Investments LLC; Chief Compliance Officer (September 2014-Present) of the PGIM Funds, Target Funds, Advanced Series Trust, The Prudential Series Fund, Prudential s Gibraltar Fund, Inc., PGIM Global Short Duration High Yield Income Fund, Inc., PGIM Short Duration High Yield Fund, Inc. and PGIM Jennison MLP Income Fund, Inc.; formerly Assistant Director (March 2010-August 2014) of the Asset Management Unit, Division of Enforcement, US Securities & Exchange Commission; Assistant Regional Director (January 2010-August 2014), Branch Chief (June 2006-December 2009) and Senior Counsel (April 2003-May 2006) of the Miami Regional Office, Division of Enforcement, US Securities & Exchange Commission.
Dino Capasso (43) Deputy Chief Compliance Officer	Since 2018	Vice President and Deputy Chief Compliance Officer (June 2017-Present) of PGIM Investments LLC; formerly, Senior Vice President and Senior Counsel (January 2016-June 2017), and Vice President and Counsel (February 2012-December 2015) of Pacific Investment Management Company LLC.
Deborah A. Docs (60) Secretary	Since 2011	Vice President and Corporate Counsel (since January 2001) of Prudential; Vice President (since December 1996) and Assistant Secretary (since March 1999) of PGIM Investments LLC; formerly Vice President and Assistant Secretary (May 2003-June 2005) of AST Investment Services, Inc.
Jonathan D. Shain (59) Assistant Secretary	Since 2011	Vice President and Corporate Counsel (since August 1998) of Prudential; Vice President and Assistant Secretary (since May 2001) of PGIM Investments LLC; Vice President and Assistant Secretary (since February 2001) of PMFS; formerly Vice President and Assistant Secretary (May 2003-June 2005) of AST Investment Services, Inc.

Management of the Fund (unaudited) (continued)

Fund Officers[a]		
Name, Address and Age Position with Fund	**Term of Office**	**Principal Occupation(s) During Past Five Years**
Claudia DiGiacomo (43) Assistant Secretary	Since 2011	Vice President and Corporate Counsel (since January 2005) of Prudential; Vice President and Assistant Secretary of PGIM Investments LLC (since December 2005); Associate at Sidley Austin Brown & Wood LLP (1999-2004).
Andrew R. French (55) Assistant Secretary	Since 2011	Vice President and Corporate Counsel (since February 2010) of Prudential; formerly Director and Corporate Counsel (2006-2010) of Prudential; Vice President and Assistant Secretary (since January 2007) of PGIM Investments LLC; Vice President and Assistant Secretary (since January 2007) of PMFS.
Brian D. Nee (52) Treasurer & Principal Financial and Accounting Officer	Since 2018	Vice President and Head of Finance of PGIM Investments LLC (since August 2015) and PGIM Global Partners (since February 2017); formerly, Vice President, Treasurer s Department of Prudential (September 2007-August 2015).
Peter Parrella (59) Assistant Treasurer	Since 2011	Vice President (since 2007) and Director (2004-2007) within Prudential Mutual Fund Administration; formerly Tax Manager at SSB Citi Fund Management LLC (1997-2004).
Lana Lomuti (49) Assistant Treasurer	Since 2014	Vice President (since 2007) and Director (2005-2007), within Prudential Mutual Fund Administration; formerly Assistant Treasurer (December 2007-February 2014) of The Greater China Fund, Inc.
Linda McMullin (56) Assistant Treasurer	Since 2014	Vice President (since 2011) and Director (2008-2011) within Prudential Mutual Fund Administration.

[a] Excludes Mr. Parker and Mr. Benjamin, Interested Directors of the Fund who also serve as President and Vice President, respectively.

Explanatory Notes to Tables:

Directors are deemed to be Interested, as defined in the 1940 Act, by reason of their affiliation with PGIM Investments LLC and/or an affiliate of PGIM Investments LLC.

Unless otherwise noted, the address of all Directors and Officers is c/o PGIM Investments LLC, 655 Broad Street, Newark, New Jersey 07102-4077.

The Board of Directors is divided into three classes, each of which has three year terms. Class I term expires in 2019, Class II term expires in 2020 and Class III term expires in 2021. Officers are generally elected by the Board to one-year terms.

There is no set term of office for Directors or Officers. The Directors have adopted a retirement policy, which calls for the retirement of Directors on December 31 of the year in which they reach the age of 75.

Other Directorships Held includes only directorships of companies required to register or file reports with the SEC under the Securities Exchange Act of 1934 (that is, public companies) or other investment companies registered under the 1940 Act.

Portfolios Overseen includes all investment companies managed by PGIM Investments LLC. The investment companies for which PGIM Investments LLC serves as manager include the PGIM Funds, The Prudential Variable Contract Accounts, Target Mutual Funds, PGIM Short Duration High Yield Fund, Inc., PGIM Global Short Duration High Yield Fund, Inc., The Prudential Series Fund, Prudential s Gibraltar Fund, Inc. and the Advanced Series Trust.

Visit our website at pgiminvestments.com

Privacy Notice

Prudential values your business and your trust. We respect the privacy of your personal information and take our responsibility to protect it seriously. This privacy notice is provided on behalf of the Prudential companies listed at the end of this notice (Prudential), and applies to our current and former customers. **This notice describes how we treat the information we receive about you, including the ways in which we will share your personal information within Prudential and your right to opt out of such sharing.**

Protecting Your Personal Information

We maintain physical, electronic and procedural safeguards to protect your personal information. The people who are authorized to have access to your personal information need it to do their jobs, and we require them to keep that information secure and confidential.

Personal Information We Collect

We collect your personal information when you fill out applications and other forms, when you enter personal details on our websites, when you respond to our emails, and when you provide us information over the telephone. We also collect personal information that others give us about you. This information includes, for example:

- name
- address, email address, telephone number, and other contact information
- income and financial information
- Social Security number
- transaction history
- medical information for insurance applications
- consumer reports from consumer reporting agencies
- participant information from organizations that purchase products or services from us for the benefit of their members or employees

Using Your Information

We use your personal information for various business purposes, including:

- normal everyday business purposes, such as providing services to you and administrating your account or policy
- business research and analysis
- marketing products and services of Prudential and other companies in which you may be interested
- as required by law

Sharing Your Information

We may share your personal information, including information about your transactions and experiences, among Prudential companies and with other non-Prudential companies who perform services for us or on our behalf, for our everyday business purposes, such as providing services to you and administering your account or policy. We may also share your personal information with another financial institution if you agree that your account or policy can be transferred to that financial company.

We may share your personal information among Prudential companies so that the Prudential companies can market their products and services to you. We may also share consumer report information among Prudential companies which may include information about you from credit reports and certain information that we receive from you and from consumer reporting agencies or other third parties. You can limit this sharing by following the instructions described in this notice. For those customers who have one of our products through a plan sponsored by an employer or other organization, we will share your personal information in a manner consistent with the terms of the plan agreement or consistent with our agreement with you.

We may also share your personal information as permitted or required by law, including, for example, to law enforcement officials and regulators, in response to subpoenas, and to prevent fraud.

Unless you agree otherwise, we do not share your personal information with non-Prudential companies for them to market their products or services to you. We may tell you about a product or service that other companies offer and, if you respond, that company will know that we selected you to receive the information.

Limiting Our Sharing Opt Out/Privacy Choice

You may tell us not to share your personal information among Prudential companies for marketing purposes, and not to share consumer report information among Prudential companies, by opting out of such sharing. To limit our sharing for these purposes:

- visit us online at: www.prudential.com/privacyoptout
- call us at: 1-877-248-4019

If you previously told us in 2016 or 2017 not to share your personal information among Prudential companies for marketing purposes, or not to share your consumer report information among Prudential companies, you do not need to tell us not to share your information again.

You are not able to limit our ability to share your personal information among Prudential companies and with other non-Prudential companies for servicing and administration purposes.

Questions

If you have any questions about how we protect, use, and share your personal information or about this privacy notice, please call us. The toll-free number is 1-877-248-4019.

We reserve the right to modify this notice at any time. This notice is also available anytime at www.prudential.com.

This notice is being provided to customers and former customers of the Prudential companies listed below.

Insurance Companies and Insurance Company Separate Accounts

The Prudential Insurance Company of America; Prudential Annuities Life Assurance Corporation; Pruco Life Insurance Company; Pruco Life Insurance Company of New Jersey;

Prudential Retirement Insurance and Annuity Company (PRIAC); CG Variable Annuity Account I & II (Connecticut General); Pruco Legacy Insurance Company of New Jersey; All insurance company separate accounts that include the following names or are otherwise identified as maintained by an entity that includes the following names: Prudential, Pruco, or PRIAC

Insurance Agencies

Prudential Insurance Agency, LLC; Mullin TBG Insurance Agency Services, LLC

Broker-Dealers and Registered Investment Advisers

AST Investment Services, Inc.; Prudential Annuities Distributors, Inc.; Global Portfolio Strategies, Inc.; Pruco Securities, LLC; PGIM, Inc.; Prudential Investment Management Services LLC; PGIM Investments LLC; Prudential Private Placement Investors, L.P., Prudential Customer Solutions LLC; Quantitative Management Associates LLC

Bank and Trust Companies

Prudential Bank & Trust, FSB; Prudential Trust Company

Investment Companies and Other Investment Vehicles

Prudential Mutual Funds; Prudential Capital Partners, L.P.; The Target Portfolio Trust; Advanced Series Trust; Prudential Private Placement Investors, Inc.; All funds that include the following names: Prudential, PCP, PGIM, or PCEP

Other Companies

Prudential Retirement Strategic Investments, LLC

Vermont Residents: We will not share information about your creditworthiness among Prudential companies, other than as permitted by Vermont law, unless you authorize us to make those disclosures.

Privacy Ed. 1/2018

MAIL
Computershare

P.O. Box 30170

College Station, TX 77842-3170

MAIL (OVERNIGHT)
Computershare

211 Quality Circle

Suite 210

College Station, TX 77845

TELEPHONE
(800) 451-6788

WEBSITE
www.pgiminvestments.com

PROXY VOTING
The Board of Directors of the Fund has delegated to the Fund s investment subadviser the responsibility for voting any proxies and maintaining proxy recordkeeping with respect to the Fund. A description of these proxy voting policies and procedures is available without charge, upon request, by calling (800) 451-6788 or by visiting the Securities and Exchange Commission s website at *www.sec.gov*. Information regarding how the Fund voted proxies relating to portfolio securities during the most recent 12-month period ended June 30 is available on the Fund s website and on the Securities and Exchange Commission s website.

MANAGER	PGIM Investments LLC	655 Broad Street Newark, NJ 07102
INVESTMENT SUBADVISER	PGIM Fixed Income	655 Broad Street Newark, NJ 07102
CUSTODIAN	The Bank of New York Mellon	225 Liberty Street New York, NY 10286
TRANSFER AGENT	Computershare Trust Company, N.A.	PO Box 30170 College Station, TX 77842-3170
INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM	KPMG LLP	345 Park Avenue New York, NY 10154
FUND COUNSEL	Sidley Austin LLP	787 Seventh Avenue New York, NY 10019

SHAREHOLDER COMMUNICATIONS WITH DIRECTORS

Shareholders can communicate directly with the Board of Directors by writing to the Chair of the Board, PGIM Short Duration High Yield Fund, Inc., PGIM Investments, Attn: Board of Directors, 655 Broad Street, Newark, NJ 07102. Shareholders can communicate directly with an individual Director by writing to the same address. Communications are not screened before being delivered to the addressee.

AVAILABILITY OF PORTFOLIO SCHEDULE

The Fund files its complete schedule of portfolio holdings with the Securities and Exchange Commission (the Commission) for the first and third quarters of each fiscal year on Form N-Q. The Fund s Forms N-Q are available on the Commission s website at *www.sec.gov*. The Fund s Forms N-Q may also be reviewed and copied at the Commission s Public Reference Room in Washington, D.C. Information on the operation and location of the Public Reference Room may be obtained by calling 1-800-SEC-0330. The Fund s schedule of portfolio holdings is also available on the Fund s website as of the end of each month no sooner than 15 days after the end of the month.

CERTIFICATIONS

The Fund s Chief Executive Officer has submitted to the New York Stock Exchange (NYSE) the required annual certifications and the Fund has also included the certifications of the Fund s Chief Executive Officer and Chief Financial Officer as required by Section 302 of the Sarbanes-Oxley Act, on the Fund s Form N-CSR filed with the Commission, for the period of this report.

This report is transmitted to shareholders of the Fund for their information. This is not a prospectus, circular, or representation intended for use in the purchase or sale of shares of the Fund or any securities mentioned in this report.

An investor should consider the investment objective, risks, charges, and expenses of the Fund carefully before investing.

Notice is hereby given in accordance with Section 23(c) of the Investment Company Act of 1940 that the Fund may purchase, from time to time, shares of its common stock at market prices.

PGIM SHORT DURATION HIGH YIELD FUND, INC.

NYSE	ISD
CUSIP	69346H100

PICE1000E

Item 2 Code of Ethics See Exhibit (a)

As of the end of the period covered by this report, the registrant has adopted a code of ethics (the Section 406 Standards for Investment Companies Ethical Standards for Principal Executive and Financial Officers) that applies to the registrant s Principal Executive Officer and Principal Financial Officer; the registrant s Principal Financial Officer also serves as the Principal Accounting Officer.

The registrant hereby undertakes to provide any person, without charge, upon request, a copy of the code of ethics. To request a copy of the code of ethics, contact the registrant 800-225-1852, and ask for a copy of the Section 406 Standards for Investment Companies - Ethical Standards for Principal Executive and Financial Officers.

Item 3 Audit Committee Financial Expert

The registrant s Board has determined that Mr. Kevin J. Bannon, member of the Board s Audit Committee is an audit committee financial expert, and that he is independent, for purposes of this Item.

Item 4 Principal Accountant Fees and Services

(a) Audit Fees

For the fiscal years ended May 31, 2018 and May 31, 2017, KPMG LLP (KPMG), the Registrant s principal accountant, billed the Registrant $43,718 and $43,285 respectively, for professional services rendered for the audit of the Registrant s annual financial statements or services that are normally provided in connection with statutory and regulatory filings.

(b) Audit-Related Fees

For the fiscal years ended May 31, 2018 and May 31, 2017: none.

(c) Tax Fees

For the fiscal years ended May 31, 2018 and May 31, 2017: none.

(d) All Other Fees

For the fiscal years ended May 31, 2018 and May 31, 2017: none.

(e) (1) Audit Committee Pre-Approval Policies and Procedures

THE PGIM MUTUAL FUNDS

AUDIT COMMITTEE POLICY

on

Pre-Approval of Services Provided by the Independent Accountants

The Audit Committee of each PGIM Mutual Fund is charged with the responsibility to monitor the independence of the Fund s independent accountants. As part of this responsibility, the Audit Committee must pre-approve the independent accounting firm s engagement to render audit and/or permissible non-audit services, as required by law. In evaluating a proposed engagement of the independent accountants, the Audit Committee will assess the effect that the engagement might reasonably be expected to have on the accountant s independence. The Committee s evaluation will be based on:

a review of the nature of the professional services expected to be provided,

a review of the safeguards put into place by the accounting firm to safeguard independence, and

periodic meetings with the accounting firm.

Policy for Audit and Non-Audit Services Provided to the Funds

On an annual basis, the scope of audits for each Fund, audit fees and expenses, and audit-related and non-audit services (and fees proposed in respect thereof) proposed to be performed by the Fund s independent accountants will be presented by the Treasurer and the independent accountants to the Audit Committee for review and, as appropriate, approval prior to the initiation of such services.

Such presentation shall be accompanied by confirmation by both the Treasurer and the independent accountants that the proposed non-audit services will not adversely affect the independence of the independent accountants. Such proposed non-audit services shall be described in sufficient detail to enable the Audit Committee to assess the appropriateness of such services and fees, and the compatibility of the provision of such services with the auditor s independence. The Committee shall receive periodic reports on the progress of the audit and other services which are approved by the Committee or by the Committee Chair pursuant to authority delegated in this Policy.

The categories of services enumerated under Audit Services , Audit-related Services , and Tax Services are intended to provide guidance to the Treasurer and the independent accountants as to those categories of services which the Committee believes are generally consistent with the independence of the independent accountants and which the Committee (or the Committee Chair) would expect upon the presentation of specific proposals to pre-approve. The enumerated categories are not intended as an exclusive list of audit,audit-related or tax services, which the Committee (or the Committee Chair) would consider for pre-approval.

Audit Services

The following categories of audit services are considered to be consistent with the role of the Fund s independent accountants:

Annual Fund financial statement audits

Seed audits (related to new product filings, as required)

- SEC and regulatory filings and consents

Audit-related Services

The following categories of audit-related services are considered to be consistent with the role of the Fund s independent accountants:

- Accounting consultations
- Fund merger support services
- Agreed Upon Procedure Reports
- Attestation Reports
- Other Internal Control Reports

Individual audit-related services that fall within one of these categories (except for fund merger support services) and are not presented to the Audit Committee as part of the annual pre-approval process are subject to an authorized pre-approval by the Audit Committee so long as the estimated fee for those services does not exceed $30,000. Any services provided under such pre-approval will be reported to the Audit Committee at its next regular meeting. Should the amount of such services exceed $30,000 any additional fees will be subject to pre-approval by the Committee Chair (or any other

Committee member on whom this responsibility has been delegated). Fees related to fund merger support services are subject to a separate authorized pre-approval by the Audit Committee with fees determined on a per occurrence and merger complexity basis.

Tax Services

The following categories of tax services are considered to be consistent with the role of the Fund s independent accountants:

- Tax compliance services related to the filing or amendment of the following:
  - Federal, state and local income tax compliance; and,
  - Sales and use tax compliance
- Timely RIC qualification reviews
- Tax distribution analysis and planning
- Tax authority examination services
- Tax appeals support services
- Accounting methods studies
- Fund merger support services
- Tax consulting services and related projects

Individual tax services that fall within one of these categories and are not presented to the Audit Committee as part of the annual pre-approval process are subject to an authorized pre-approval by the Audit Committee so long as the estimated fee for those services does not exceed $30,000. Any services provided under such pre-approval will be reported to the Audit Committee at its next regular meeting. Should the amount of such services exceed $30,000 any additional fees will be subject to pre-approval by the Committee Chair (or any other Committee member on whom this responsibility has been delegated).

Other Non-Audit Services

Certain non-audit services that the independent accountants are legally permitted to render will be subject to pre-approval by the Committee or by one or more Committee members to whom the Committee has delegated this authority and who will report to the full Committee any pre-approval decisions made pursuant to this Policy. Non-audit services presented for pre-approval pursuant to this paragraph will be accompanied by a confirmation from both the Treasurer and the independent accountants that the proposed services will not adversely affect the independence of the independent accountants.

Proscribed Services

The Fund s independent accountants will not render services in the following categories of non-audit services:

- Bookkeeping or other services related to the accounting records or financial statements of the Fund
- Financial information systems design and implementation
- Appraisal or valuation services, fairness opinions, or contribution-in-kind reports
- Actuarial services
- Internal audit outsourcing services
- Management functions or human resources
- Broker or dealer, investment adviser, or investment banking services
- Legal services and expert services unrelated to the audit
- Any other service that the Public Company Accounting Oversight Board determines, by regulation, is impermissible.

Pre-approval of Non-Audit Services Provided to Other Entities Within the PGIM Fund Complex

Certain non-audit services provided to PGIM Investments LLC or any of its affiliates that also provide ongoing services to the PGIM Mutual Funds will be subject to pre-approval by the Audit Committee. The only non-audit services provided to these entities that will require pre-approval are those related directly to the operations and financial reporting of the Funds. Individual projects that are not presented to the Audit Committee as part of the annual pre-approval process will be subject to pre-approval by the Committee Chair (or any other Committee member on whom this responsibility has been delegated) so long as the estimated fee for those services does not exceed $30,000. Services presented for pre-approval pursuant to this paragraph will be accompanied by a confirmation from both the Treasurer and the independent accountants that the proposed services will not adversely affect the independence of the independent accountants.

Although the Audit Committee will not pre-approve all services provided to PGIM Investments LLC and its affiliates, the Committee will receive an annual report from the Fund s independent accounting firm showing the aggregate fees for all services provided to PGIM Investments and its affiliates.

(e) (2) Percentage of services referred to in 4(b) 4(d) that were approved by the audit committee For the fiscal years ended May 31, 2018 and May 31, 2017: none.

(f) Percentage of hours expended attributable to work performed by other than full time employees of principal accountant if greater than 50%.

The percentage of hours expended on the principal accountant s engagement to audit the registrant s financial statements for the most recent fiscal year that were attributed to work performed by persons other than the principal accountant s full-time, permanent employees was 0%.

(g) Non-Audit Fees

The aggregate non-audit fees billed by KPMG for services rendered to the registrant s investment adviser and any entity controlling, controlled by, or under common control with the investment adviser that provides ongoing services to the registrant for the fiscal years ended May 31, 2018 and May 31, 2017 was $0 and $0, respectively.

(h) Principal Accountant s Independence

Not applicable as KPMG has not provided non-audit services to the registrant s investment adviser and any entity controlling, controlled by, or under common control with the investment adviser that provides ongoing services to the registrant that were not pre-approved pursuant to Rule 2-01(c)(7)(ii) of Regulation S-X.

Item 5 Audit Committee of Listed Registrants

The registrant has a separately designated standing audit committee (the Audit Committee) established in accordance with Section 3(a)(58)(A) of the Securities Exchange Act of 1934. The members of the Audit Committee are Kevin J. Bannon (chair), Ellen S. Alberding, Linda W. Bynoe, and Richard A. Redeker (ex-officio).

Item 6 Schedule of Investments The schedule is included as part of the report to shareholders filed under Item 1 of this Form. Item 7 Disclosure of Proxy Voting Policies and Procedures for Closed-End Management Investment Companies

PROXY VOTING POLICIES OF THE SUBADVISER

PGIM FIXED INCOME

Our policy is to vote proxies in the best economic interest of our clients. In the case of pooled accounts, our policy is to vote proxies in the best economic interest of the pooled account. Our proxy voting policy contains detailed voting guidelines on a wide variety of issues commonly voted upon by shareholders. These guidelines reflect our judgment of how to further the best economic interest of our clients through the shareholder or debt-holder voting process.

PGIM Fixed Income invests primarily in debt securities, thus there are few traditional proxies voted by us. We generally vote with management on routine matters such as the appointment of accountants or the election of directors. From time to time, ballot issues arise that are not addressed by our policy or circumstances may suggest a vote not in accordance with our established guidelines. In these cases, voting decisions are made on a case-by-case basis by the applicable portfolio manager taking into consideration the potential economic impact of the proposal. Not all ballots are received by us in advance of voting deadlines, but when ballots are received in a timely fashion, we strive to meet our voting obligations. We cannot, however, guarantee that every proxy will be voted prior to its deadline.

With respect to non-U.S. holdings, we take into account additional restrictions in some countries that might impair our ability to trade those securities or have other potentially adverse economic consequences. We generally vote non-U.S. securities on a best efforts basis if we determine that voting is in the best economic interest of our clients.

Occasionally, a conflict of interest may arise in connection with proxy voting. For example, the issuer of the securities being voted may also be a client of ours. When we identify an actual or potential material conflict of interest between the firm and our clients with respect to proxy voting, the matter is presented to senior management who will resolve such issue in consultation with the compliance and legal departments. Proxy voting is reviewed by our trade management oversight committee.

Any client may obtain a copy of our proxy voting policy, guidelines and procedures, as well as the proxy voting records for that client s securities, by contacting the account management representative responsible for the client s account.

Item 8 Portfolio Managers of Closed-End Management Investment Companies

Portfolio Managers

The following individuals have primary responsibility for the day-to-day implementation of the Fund s investment strategy.

Robert Cignarella, CFA, is a Managing Director and Head of PGIM Fixed Income s Leveraged Finance Team, which includes the US and European High Yield Bond and Bank Loan sector teams. Previously, Mr. Cignarella was a managing director and co-head of high yield and bank loans at Goldman Sachs Asset Management. He also held positions as a high yield portfolio manager and a high yield and investment grade credit analyst. Earlier, he was a financial analyst in the investment banking division of Salomon Brothers. Mr. Cignarella received an MBA from the University of Chicago, and a bachelor s degree in operations research and industrial engineering from Cornell University. He holds the Chartered Financial Analyst (CFA) designation.

Daniel Thorogood, CFA, is a Vice President and a high yield portfolio manager for PGIM Fixed Income s High Yield Team. Mr. Thorogood is also responsible for portfolio strategy and managing high yield bond allocations in multi-sector portfolios. Prior to joining the High Yield Team, Mr. Thorogood was a member of PGIM Fixed Income s Quantitative Research and Risk Management Group. Mr. Thorogood was the head of a team of portfolio analysts who support the Firm s credit-related strategies, including investment grade corporate, high yield corporate, and emerging market debt sectors. The team was primarily responsible for performing detailed portfolio analysis relative to benchmarks, monitoring portfolio risk exposures, and analyzing performance through proprietary return attribution models. Prior to joining the Quantitative Research and Risk Management Group in 1996, Mr. Thorogood was Associate Manager in PGIM Fixed Income s Trade Support and Operations Unit. He received a BS in Finance from Florida State University and an MBA in Finance from Rutgers University. Mr. Thorogood holds the Chartered Financial Analyst (CFA) designation.

Brian Clapp, CFA, is a Principal and a high yield portfolio manager for PGIM Fixed Income s High Yield Team. Mr. Clapp was previously a senior high yield credit analyst on PGIM Fixed Income s Credit Research team. He joined the Firm in 2006 from Muzinich & Co. While there, Mr. Clapp held several positions, including portfolio manager for a high yield bond based hedge fund, hedge fund credit analyst, and credit analyst covering the chemical, industrial, and transportation sectors. Earlier at Triton Partners, an institutional high yield fund manager, Mr. Clapp was a credit analyst covering the metals and mining, healthcare, homebuilding, building products and transportation sectors. He received a BS in Finance from Bryant College, and an MS in Computational Finance, and an MBA from Carnegie Mellon. Mr. Clapp holds the Chartered Financial Analyst (CFA) designation.

Robert Spano, CFA, CPA, is a Principal and a high yield portfolio manager for PGIM Fixed Income s High Yield Bond Team. Prior to assuming his current position in 2007, Mr. Spano was a high yield credit analyst for 10 years in PGIM Fixed Income s Credit Research Group, covering the health, lodging, consumer, gaming, restaurants, and chemical industries. Earlier, he worked as an investment analyst in the Project Finance Unit of the Firm s private placement group. Mr. Spano also held positions in the internal audit and risk management units of Prudential Securities. He received a BS in Accounting from the University of Delaware and an MBA from New York University. Mr. Spano holds the Chartered Financial Analyst (CFA) and Certified Public Accountant (CPA) designations.

Ryan Kelly, CFA, is a Principal and a high yield portfolio manager for PGIM Fixed Income s High Yield Team. Prior to his current position, Mr. Kelly was a senior high yield credit analyst in PGIM Fixed Income s Credit Research Group, covering the automotive, energy, technology and finance sectors. Previously, Mr. Kelly was a senior high yield bond analyst at Muzinich & Company. Earlier, he was an investment banker at PNC Capital Markets/PNC Bank where he worked in the high yield bond, mergers and acquisition (M&A) and loan syndication groups. Mr. Kelly began his career in investment banking at Chase Manhattan Bank, working on project finance transactions and M&A advisory mandates for the electric power sector. He received a BA in Economics from Michigan State University and holds the Chartered Financial Analyst (CFA) designation.

Terence Wheat, CFA, is a Principal, global high yield portfolio manager and an emerging markets corporate portfolio manager at PGIM Fixed Income. Previously, he was a high yield portfolio manager for PGIM Fixed Income s High Yield Team for six years. Mr. Wheat also spent 12 years as a credit analyst in PGIM Fixed Income s Credit Research Group, where he was responsible for the consumer products, gaming and leisure, retail, supermarkets, and textile/apparel industries. Mr. Wheat covered high yield bonds from 1998 to 2003, and investment grade issues from 1993 to 1998. Earlier, he worked for the Firm s Financial Management Group.

Mr. Wheat joined the Firm in 1988. He received a BS in Accounting and an MBA from Rider University. Mr. Wheat holds the Chartered Financial Analyst (CFA) designation.

Other Accounts Managed by the Portfolio Managers. The following tables set forth certain information with respect to the portfolio managers for the Fund. Unless noted otherwise, all information is provided as of June 30, 2017.

The table below identifies, for each portfolio manager, the number of accounts (other than the Fund) for which the portfolio manager has day-to-day management responsibilities and the total assets in such accounts, within each of the following categories: registered investment companies, other pooled investment vehicles, and other accounts. For each category, the number of accounts and total assets in the accounts whose fees are based on performance is indicated in *italic typeface*. In addition is information about portfolio manager ownership of Fund securities. The Ownership of Fund Securities column shows the dollar range of equity securities of the Fund beneficially owned by the portfolio manager.

Portfolio Managers	Registered Investment Companies/ Total Assets	Other Pooled Investment Vehicles	Other Accounts/ Total Assets	Fund Ownership
Robert Spano, CFA, CPA	30/ $13,721,867,510	18 / $7,083,626,254	112 / $14,244,264,566	$10,001-$50,000
Terence Wheat, CFA	30 / $13,721,867,510	18 / $7,083,626,254	112 / $14,244,264,566	$50,001-$100,000
Daniel Thorogood, CFA	30 / $13,721,867,510	18 / $7,083,626,254	112 / $14,244,264,566	$50,001-$100,000
	30 / $13,721,867,510	18 / $7,083,626,254	112 / $14,244,264,566	$50,001-$100,000

Ryan Kelly, CFA				
Brian Clapp, CFA	30 / $13,721,867,510	18 / $7,083,626,254	112 / $14,244,264,566	$50,001-$100,000
Robert Cignarella, CFA	30 / $14,540,517,250	18 / $7,083,626,254	112 / $14,712,682,372	$0

Compensation and Conflicts Disclosure:

Compensation

General

The base salary of an investment professional in the PGIM Fixed Income unit of PGIM, Inc. is based on market data relative to similar positions as well as the past performance, years of experience and scope of responsibility of the individual. Incentive compensation, including the annual cash bonus, the long-term equity grant and grants under PGIM Fixed Income s long-term incentive plans, is primarily based on such person s contribution to PGIM Fixed Income s goal of providing investment performance to clients consistent with portfolio objectives, guidelines and risk parameters and market-based data such as compensation trends and levels of overall compensation for similar positions in the asset management industry. In addition, an investment professional s qualitative contributions to the organization and its commercial success are considered in determining incentive compensation. Incentive compensation is not solely based on the performance of, or value of assets in, any single account or group of client accounts.

An investment professional s annual cash bonus is paid from an annual incentive pool. The pool is developed as a percentage of PGIM Fixed Income s operating income and the percentage used to calculate the pool may be refined by factors such as:

- business initiatives;
- the number of investment professionals receiving a bonus and related peer group compensation;
- financial metrics of the business relative to those of appropriate peer groups; and
- investment performance of portfolios: (i) relative to appropriate peer groups; and/or (ii) as measured against relevant investment indices.

Long-term compensation consists of Prudential Financial restricted stock and grants under the long-term incentive plan and targeted long-term incentive plan. Grants under the long-term incentive plan and targeted long-term incentive plan are participation interests in notional accounts with a beginning value of a specified dollar amount. For the long-term incentive plan, the value attributed to these notional accounts increases or decreases over a defined period of time based, in part, on the performance of investment composites representing a number of PGIM Fixed Income s investment strategies. With respect to targeted long-term incentive awards, the value attributed to the notional accounts increases or decreases over a defined period of time based on the performance of either (i) a long/short investment composite or (ii) a commingled investment vehicle. An investment composite is an aggregation of accounts with similar investment strategies. The long-term incentive plan is designed to more closely align compensation with investment performance and the growth of PGIM Fixed Income s business. The targeted long-term incentive plan is designed to align the interests of certain of PGIM Fixed Income s investment professionals with the performance of a particular long/short composite or commingled investment vehicle. The chief investment officer/head of PGIM Fixed Income also receives (i) performance shares which represent the right to receive shares of Prudential Financial common stock conditioned upon, and subject to, the achievement of specified financial performance goals by Prudential Financial; (ii) book value units which track the book value per share of Prudential Financial; and (iii) Prudential Financial stock options. Each of the restricted stock, long-term incentive plan grants, performance shares, book value units and stock options is subject to vesting requirements.

CONFLICTS OF INTEREST. Like other investment advisers, PGIM Fixed Income is subject to various conflicts of interest in the ordinary course of its business. PGIM Fixed Income strives to identify potential risks, including conflicts of interest, that are inherent in its business, and conducts annual conflict of interest reviews. When actual or potential conflicts of interest are identified, PGIM Fixed Income seeks to address such conflicts through one or more of the following methods:

- elimination of the conflict;
- disclosure of the conflict; or
- management of the conflict through the adoption of appropriate policies, procedures or other mitigants.

PGIM Fixed Income follows the policies of Prudential Financial, Inc. (Prudential Financial) on business ethics, personal securities trading by investment personnel, and information barriers. PGIM Fixed Income has adopted a code of ethics, allocation policies and conflicts of interest policies, among others, and has adopted supervisory procedures to monitor compliance with its policies. PGIM Fixed Income cannot guarantee, however, that its policies and procedures will detect and prevent, or result in the disclosure of, each and every situation in which a conflict may arise.

Side-by-Side Management of Accounts and Related Conflicts of Interest. PGIM Fixed Income s side-by-side management of multiple accounts can create conflicts of interest. Examples are detailed below, followed by a discussion of how PGIM Fixed Income addresses these conflicts.

- Performance Fees PGIM Fixed Income manages accounts with asset-based fees alongside accounts with performance- based fees. This side-by-side management may be deemed to create an incentive for PGIM Fixed Income and its investment professionals to favor one account over another. Specifically, PGIM Fixed Income or its affiliates could be considered to have the incentive to favor accounts for which PGIM Fixed Income or an affiliate receives performance fees, and possibly take greater investment risks in those accounts, in order to bolster performance and increase its fees.
- Affiliated accounts PGIM Fixed Income manages accounts on behalf of its affiliates as well as unaffiliated accounts. PGIM Fixed Income could be considered to have an incentive to favor accounts of affiliates over others.

Large accounts/higher fee strategies large accounts and clients typically generate more revenue than do smaller accounts or clients and certain of PGIM Fixed Income s strategies have higher fees than others. As a result, a portfolio manager could be considered to have an incentive when allocating scarce investment opportunities to favor accounts that pay a higher fee or generate more income for PGIM Fixed Income.

Long only and long/short accounts PGIM Fixed Income manages accounts that only allow it to hold securities long as well as accounts that permit short selling. PGIM Fixed Income may, therefore, sell a security short in some client accounts while holding the same security long in other client accounts. These short sales could reduce the value of the securities held in the long only accounts. In addition, purchases for long only accounts could have a negative impact on the short positions.

Securities of the same kind or class PGIM Fixed Income sometimes buys or sells for one client account securities of the same kind or class that are purchased or sold for another client at prices that may be different. PGIM Fixed Income may also, at any time, execute trades of securities of the same kind or class in one direction for an account and in the opposite direction for another account due to differences in price, investment strategy or client direction. Different strategies trading in the same securities or types of securities may appear as inconsistencies in PGIM Fixed Income s management of multiple accounts side-by-side.

Investment at different levels of an issuer s capital structure PGIM Fixed Income may invest client assets in the same issuer, but at different levels in the capital structure. In the event of restructuring or insolvency, PGIM Fixed Income may exercise remedies and take other actions on behalf of the holders of senior debt that are not in the interest of, or are adverse to, other clients that are the holders of junior debt, or vice versa.

Financial interests of investment professionals - PGIM Fixed Income investment professionals may invest in certain investment vehicles that it manages, including mutual funds and private funds. Also, certain of these investment vehicles are options under the 401(k) and deferred compensation plans offered by Prudential Financial. In addition, the value of grants under PGIM Fixed Income s long-term incentive plan and targeted long-term incentive plan is affected by the performance of certain client accounts. As a result, PGIM Fixed Income investment professionals may have financial interests in accounts managed by PGIM Fixed Income or that are related to the performance of certain client accounts.

Non-discretionary accounts PGIM Fixed Income provides non-discretionary investment advice to some clients and manages others on a discretionary basis. Trades in non-discretionary accounts or accounts where discretion is limited could occur before, in concert with, or after PGIM Fixed Income executes similar trades in its discretionary accounts. The non-discretionary/limited discretion clients may be disadvantaged if PGIM Fixed Income delivers investment advice to them after it initiates trading for the discretionary clients, or vice versa.

How PGIM Fixed Income Addresses These Conflicts of Interest. PGIM Fixed Income has developed policies and procedures designed to address the conflicts of interest with respect to its different types of side-by-side management described above.

Quarterly Strategy Reviews. Each quarter, the chief investment officer/head of PGIM Fixed Income holds a series of meetings with the senior portfolio manager and team responsible for the management of each of PGIM Fixed Income s investment strategies. At each meeting, the chief investment officer/head of PGIM Fixed Income and strategy teams review and discuss the investment performance and performance attribution for each client account managed in the applicable strategy. These meetings are also typically attended by PGIM Fixed Income s chief compliance officer or his designee and head of investment risk management or his designee.

Quarterly Senior Management Investment Review. Each quarter, the chief investment officer/head of PGIM Fixed Income reviews the investment performance and performance attribution of each of our strategies during a meeting typically attended by members of PGIM Fixed Income s senior leadership team, chief compliance officer or his designee, head of investment risk management or his designee and senior portfolio managers.

In keeping with PGIM Fixed Income s fiduciary obligations, its policy with respect to trade aggregation and allocation is to treat all of its client accounts fairly and equitably over time. PGIM Fixed Income s trade management oversight committee, which generally meets quarterly, is responsible for providing oversight with respect to trade aggregation and allocation. Its compliance group periodically reviews a sampling of new issue allocations and related documentation to confirm compliance with the trade aggregation and allocation procedures. In addition, the compliance and investment risk management groups review forensic reports regarding new issue and secondary trade activity on a quarterly basis. This forensic analysis includes such data as the: (i) number of new issues allocated in the strategy; (ii) size of new issue allocations to each portfolio in the strategy; (iii) profitability of new issue transactions; and (iv) portfolio turnover. The results of these analyses are reviewed and discussed at PGIM Fixed Income s trade management oversight committee meetings. The procedures above are designed to detect patterns and anomalies in PGIM Fixed Income s side-by-side management and trading so that it may assess and improve its processes.

PGIM Fixed Income has procedures that specifically address its side-by-side management of long/short and long only portfolios. These procedures address potential conflicts that could arise from differing positions between long/short and long only portfolios. In addition, lending opportunities with respect to securities for which the market is demanding a slight premium rate over normal market rates are allocated to long only accounts prior to allocating the opportunities to long/short accounts.

Conflicts Related to PGIM Fixed Income s Affiliations. As an indirect wholly-owned subsidiary of Prudential Financial, PGIM Fixed Income is part of a diversified, global financial services organization. PGIM Fixed Income is affiliated with many types of U.S. and non-U.S. financial service providers, including insurance companies, broker-dealers, commodity trading advisors, commodity pool operators and other investment advisers. Some of its employees are officers of and/or provide services to some of these affiliates.

Conflicts Arising Out of Legal Restrictions. PGIM Fixed Income may be restricted by law, regulation, contract or other constraints as to how much, if any, of a particular security it may purchase or sell on behalf of a client, and as to the timing of such purchase or sale. Sometimes these restrictions apply as a result of its relationship with Prudential Financial and its other affiliates. For example, PGIM Fixed Income does not purchase securities issued by Prudential Financial for client accounts. In addition, PGIM Fixed Income s holdings of a security on behalf of its clients are required, under certain regulations, to be aggregated with the holdings of that security by other Prudential Financial affiliates. These holdings could, on an aggregate basis, exceed certain reporting or ownership thresholds. Prudential Financial tracks these aggregated holdings and may restrict purchases to avoid crossing such thresholds because of the potential consequences to Prudential Financial if such thresholds are exceeded. In addition, PGIM Fixed Income could receive material, non-public information with respect to a particular issuer and, as a result, be unable to execute transactions in securities of that issuer for its clients. For example, PGIM Fixed Income s bank loan team often invests in private bank loans in connection with which the borrower provides material, non-public information, resulting in restrictions on trading securities issued by those borrowers. PGIM Fixed Income has procedures in place to carefully consider whether to intentionally accept material, non-public information with respect to certain issuers. PGIM Fixed Income is generally able to avoid receiving material, non-public information from its affiliates and other units within PGIM, Inc. by maintaining information barriers. In some instances, it may create an isolated information barrier around a small number of its employees so that material, non-public information received by such employees is not attributed to the rest of PGIM Fixed Income.

Conflicts Related to Outside Business Activity. From time to time, certain of PGIM Fixed Income employees or officers may engage in outside business activity, including outside directorships. Any outside business activity is subject to prior approval pursuant to PGIM Fixed Income s personal conflicts of interest and outside business activities policy. Actual and potential conflicts of interest are analyzed during such approval process. PGIM Fixed Income could be restricted in trading the securities of certain issuers in client portfolios in the unlikely event that an employee or officer, as a result of outside business activity, obtains material, non-public information regarding an issuer.

Conflicts Related to Investment of Client Assets in Affiliated Funds. PGIM Fixed Income may invest client assets in funds that it manages or subadvises for an affiliate. PGIM Fixed Income may also invest cash collateral from securities lending transactions in these funds. These investments benefit both PGIM Fixed Income and its affiliate.

PICA General Account. Because of the substantial size of the general accounts of our affiliated insurance companies, trading by these general accounts, including PGIM Fixed Income s trades on behalf of the accounts, may affect the market prices or limit the availability of the securities or instruments transacted. Although PGIM Fixed Income does not expect that the general accounts will execute transactions that will move a market frequently, and generally only in response to unusual market or issuer events, the execution of these transactions could have an adverse effect on transactions for or positions held by other clients.

Conflicts Related to Co-investment by Affiliates

PGIM Fixed Income affiliates may provide initial funding or otherwise invest in vehicles it manages. When an affiliate provides seed capital or other capital for a fund, it may do so with the intention of redeeming all or part of its interest at a future point in time or when it deems that sufficient additional capital has been invested in that fund.

The timing of a redemption by an affiliate could benefit the affiliate. For example, the fund may be more liquid at the time of the affiliate s redemption than it is at times when other investors may wish to withdraw all or part of their interests.

In addition, a consequence of any withdrawal of a significant amount, including by an affiliate, is that investors remaining in the fund will bear a proportionately higher share of fund expenses following the redemption.

PGIM Fixed Income could also face a conflict if the interests of an affiliated investor in a fund it manages diverge from those of the fund or other investors. For example, PGIM Fixed Income affiliates, from time to time, hedge some or all of the risks associated with their investments in certain funds PGIM Fixed Income manages. PGIM Fixed Income may provide assistance in connection with this hedging activity.

PGIM Fixed Income believes that these conflicts are mitigated by its allocation policies and procedures, its supervisory review of accounts and its procedures with respect to side-by-side management of long only and long/short accounts.

Conflicts Arising Out of Industry Activities

PGIM Fixed Income and its affiliates have service agreements with various vendors that are also investment consultants. Under these agreements, PGIM Fixed Income or its affiliates compensate the vendors for certain services, including software, market data and technology services. PGIM Fixed Income s clients may also retain these vendors as investment consultants. The existence of these service agreements may provide an incentive for the investment consultants to favor PGIM Fixed Income when they advise their clients. PGIM Fixed Income does not, however, condition its purchase of services from consultants upon their recommending PGIM Fixed Income to their clients. PGIM Fixed Income will provide clients with information about services that it obtains from these consultants upon request.

PGIM Fixed Income retains third party advisors and other service providers to provide various services for PGIM Fixed Income as well as for funds that PGIM Fixed Income manages or subadvises. A service provider may provide services to PGIM Fixed Income or one of PGIM Fixed Income s funds while also providing services to other PGIM units, other PGIM-advised funds, or affiliates of PGIM, and may negotiate rates in the context of the overall relationship. PGIM Fixed Income may benefit from negotiated fee rates offered to its funds and vice versa. There is no assurance, however, that PGIM Fixed Income will be able to obtain advantageous fee rates from a given service provider negotiated by its affiliates based on their relationship with the service provider, or that PGIM Fixed Income will know of such negotiated fee rates.

Conflicts Related to Securities Holdings and Other Financial Interests

Prudential Financial, PICA, PGIM Fixed Income and other affiliates of PGIM at times have financial interests in, or relationships with, companies whose securities or related instruments PGIM Fixed Income holds, purchases or sells in its client accounts. Certain of these interests and relationships are material to PGIM Fixed Income or to the Prudential enterprise. At any time, these interests and relationships could be inconsistent or in potential or actual conflict with positions held or actions taken by PGIM Fixed Income on behalf of PGIM Fixed Income s client accounts. For example:

PGIM Fixed Income invests in the securities of one or more clients for the accounts of other clients.

PGIM Fixed Income s affiliates sell various products and/or services to certain companies whose securities PGIM Fixed Income purchases and sells for PGIM Fixed Income clients.

PGIM Fixed Income invests in the debt securities of companies whose equity is held by its affiliates.

PGIM Fixed Income s affiliates hold public and private debt and equity securities of a large number of issuers and may invest in some of the same issuers for other client accounts but at different levels in the capital structure. For example:

Affiliated accounts can hold the senior debt of an issuer whose subordinated debt is held by PGIM Fixed Income s clients or hold secured debt of an issuer whose public unsecured debt is held in client accounts. In the event of restructuring or insolvency, the affiliated accounts as holders of senior debt may exercise remedies and take other actions that are not in the interest of, or are adverse to, other clients that are the holders of junior debt.

To the extent permitted by applicable law, PGIM Fixed Income may also invest client assets in offerings of securities the proceeds of which are used to repay debt obligations held in affiliated accounts or other client accounts. PGIM Fixed Income s interest in having the debt repaid creates a conflict of interest, PGIM Fixed Income has adopted a refinancing policy to address this conflict.

Certain of PGIM Fixed Income s affiliates (as well as directors or officers of its affiliates) are officers or directors of issuers in which PGIM Fixed Income invests from time to time. These issuers may also be service providers to PGIM Fixed Income or its affiliates.

In addition, PGIM Fixed Income may invest client assets in securities backed by commercial mortgage loans that were originated or are serviced by an affiliate.

In general, conflicts related to the financial interests described above are addressed by the fact that PGIM Fixed Income makes investment decisions for each client independently considering the best economic interests of such client.

Conflicts Related to the Offer and Sale of Securities. Certain of PGIM Fixed Income s employees may offer and sell securities of, and interests in, commingled funds that it manages or subadvises. There is an incentive for PGIM Fixed Income s employees to offer these securities to investors regardless of whether the investment is appropriate for such investor since increased assets in these vehicles will result in increased advisory fees to it. In addition, such sales could result in increased compensation to the employee.

Conflicts Related to Long-Term Compensation. The performance of many client accounts is not reflected in the calculation of changes in the value of participation interests under PGIM Fixed Income s long-term incentive plan. This may be because the composite representing the strategy in which the account is managed is not one of the composites included in the calculation or because the account is excluded from a specified composite due to guideline restrictions or other factors. In addition, the performance of only a small number of our investment strategies is covered under PGIM Fixed Income s targeted long-term incentive plan. As a result of the long-term incentive plan and targeted long-term incentive plan, PGIM Fixed Income s portfolio managers from time to time have financial interests related to the investment performance of some, but not all, of the accounts they manage. To address potential conflicts related to these financial interests, PGIM Fixed Income has procedures, including trade allocation and supervisory review procedures, designed to confirm that each of its client accounts is managed in a manner that is consistent with PGIM Fixed Income s fiduciary obligations, as well as with the account s investment objectives, investment strategies and restrictions. For example, PGIM Fixed Income s chief investment officer/head reviews performance among similarly managed accounts on a quarterly basis during meetings typically attended by members of PGIM Fixed Income s senior leadership team, chief compliance officer or his designee, head of investment risk management or his designee and senior portfolio managers.

Conflicts Related to Trading Personal Trading by Employees. Personal trading by PGIM Fixed Income employees creates a conflict when they are trading the same securities or types of securities as PGIM Fixed Income trades on behalf of its clients. This conflict is mitigated by PGIM Fixed Income s personal trading standards and procedures.

In general, conflicts related to the securities holdings and financial interests described above are addressed by the fact that PGIM Fixed Income makes investment decisions for each client independently considering the best economic interests of such client.

Conflicts Related to Valuation and Fees.

When client accounts hold illiquid or difficult to value investments, PGIM Fixed Income faces a conflict of interest when making recommendations regarding the value of such investments since its management fees are generally based on the value of assets under management. PGIM Fixed Income believes that its valuation policies and procedures mitigate this conflict effectively and enable it to value client assets fairly and in a manner that is consistent with the client s best interests. In addition, single client account clients often calculate fees based on the valuation of assets provided by their custodian or administrator.

Conflicts Related to Securities Lending Fees

When PGIM Fixed Income manages a client account and also serves as securities lending agent for the account, it could be considered to have the incentive to invest in securities that would generate higher securities lending returns, but may not otherwise be in the best interest of the client account.

Item 9 Purchases of Equity Securities by Closed-End Management Investment Company and Affiliated Purchasers There have been no purchases of equity securities by the registrant or any affiliated purchasers during the period covered by this report.

Item 10 Submission of Matters to a Vote of Security Holders There have been no material changes to these procedures.

Item 11 Controls and Procedures

(a) It is the conclusion of the registrant s principal executive officer and principal financial officer that the effectiveness of the registrant s current disclosure controls and procedures (such disclosure controls and procedures having been evaluated within 90 days of the date of this filing) provide reasonable assurance that the information required to be disclosed by the registrant has been recorded, processed, summarized and reported within the time period specified in the Commission s rules and forms and that the information required to be disclosed by the registrant has been accumulated and communicated to the registrant s principal executive officer and principal financial officer in order to allow timely decisions regarding required disclosure.

(b) There has been no significant change in the registrant s internal control over financial reporting that occurred during the registrant s most recent fiscal quarter of the period covered by this report that has materially affected, or is likely to materially affect, the registrant s internal control over financial reporting.

Item 12 Exhibits

(a) (1) Code of Ethics Attached hereto as Exhibit EX-99.CODE-ETH

(2) Certifications pursuant to Section 302 of the Sarbanes-Oxley Act Attached hereto as Exhibit EX-99.CERT.

(3) Any written solicitation to purchase securities under Rule 23c-1. Not applicable.

(b) Certifications pursuant to Section 906 of the Sarbanes-Oxley Act Attached hereto as Exhibit EX-99.906CERT.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934 and the Investment Company Act of 1940, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Registrant: PGIM Short Duration High Yield Fund, Inc.

By: /s/ Deborah A. Docs
Deborah A. Docs
Secretary

Date: July 18, 2018

Pursuant to the requirements of the Securities Exchange Act of 1934 and the Investment Company Act of 1940, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

By: /s/ Stuart S. Parker
Stuart S. Parker
President and Principal Executive Officer

Date: July 18, 2018

By: /s/ Brian D. Nee
Brian D. Nee
Treasurer and Principal Financial and Accounting Officer

Date: July 18, 2018