2U, Inc.
Form 10-Q
August 04, 2016
Table of Contents

# UNITED STATES
# SECURITIES AND EXCHANGE COMMISSION

**Washington, D.C. 20549**

# FORM 10-Q

**(Mark One)**

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

**For the quarterly period ended June 30, 2016**

**or**

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

**For the transition period from to**

**Commission File Number: 001-36376**

# 2U, INC.

(Exact name of registrant as specified in its charter)

| | |
|---|---|
| **Delaware**<br>(State or other jurisdiction of incorporation or organization) | **26-2335939**<br>(I.R.S. Employer Identification No.) |
| **8201 Corporate Drive, Suite 900**<br>**Landover, MD**<br>(Address of principal executive offices) | **20785**<br>(Zip Code) |

**(301) 892-4350**

(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. x Yes o No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). x Yes o No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, non-accelerated filer or a smaller reporting company. See 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 o |
| Non-accelerated filer o | Smaller reporting company o |

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

As of August 2, 2016, there were 46,880,159 shares of the registrant s common stock, par value $0.001 per share, outstanding.

Table of Contents

**TABLE OF CONTENTS**

Table of Contents

## SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 and which are subject to substantial risks and uncertainties. In some cases, you can identify forward-looking statements by the words may, might, will, could, would, should, expect, intend, plan, objective, anticipate, believe, estimate, predict, project, p or the negative of these terms, or other comparable terminology intended to identify statements about the future. These statements involve known and unknown risks, uncertainties and other factors that may cause our actual results, levels of activity, performance or achievements to be materially different from the information expressed or implied by these forward-looking statements. Although we believe that we have a reasonable basis for each forward-looking statement contained in this Quarterly Report on Form 10-Q, we caution you that these statements are based on a combination of facts and factors currently known by us and our expectations of the future, about which we cannot be certain. Forward-looking statements include statements about:

- trends in the higher education market and the market for online education, and expectations for growth in those markets;
- the acceptance, adoption and growth of online learning by colleges and universities, faculty, students, employers, accreditors and state and federal licensing bodies;
- the potential benefits of our cloud-based software-as-a-service ( SaaS ) technology and technology-enabled services to clients and students;
- anticipated launch dates of new client programs;
- the predictability, visibility and recurring nature of our business model;
- our ability to acquire new clients and expand programs with existing clients, including in the international, undergraduate and doctoral markets;
- our ability to continue to acquire prospective students for our clients programs;
- our ability to affect or increase student retention in our clients programs;

- our growth strategy;

- the scalability of our cloud-based SaaS technology;

- our expected expenses in future periods and their relationship to revenue;

- potential changes in regulations applicable to us or our clients; and

- the amount of time that we expect our cash balances and other available financial resources to be sufficient to fund our operations.

You should refer to the risks described in Part I, Item 1A Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2015 for a discussion of important factors that may cause our actual results to differ materially from those expressed or implied by our forward-looking statements. As a result of these factors, we cannot assure you that the forward-looking statements in this Quarterly Report on Form 10-Q will prove to be accurate. Furthermore, if our forward-looking statements prove to be inaccurate, the inaccuracy may be material. In light of the significant uncertainties in these forward-looking statements, you should not regard these statements as a representation or warranty by us or any other person that we will achieve our objectives and plans in any specified timeframe, or at all. We undertake no obligation to publicly update any forward-looking statements, whether as a result of new information, future events or otherwise, except as required by law.

You should read this Quarterly Report on Form 10-Q completely and with the understanding that our actual future results may be materially different from what we expect. We qualify all of our forward-looking statements by these cautionary statements.

Table of Contents

**PART I. FINANCIAL INFORMATION**

## Item 1. Financial Statements

**2U, Inc.**

**Condensed Consolidated Balance Sheets**

**(unaudited, in thousands, except share and per share amounts)**

| | June 30, 2016 | December 31, 2015 |
|---|---|---|
| **Assets** | | |
| Current assets: | | |
| Cash and cash equivalents | $ 188,251 | $ 183,729 |
| Accounts receivable, net | 5,242 | 975 |
| Advance to clients | 1,125 | 1,508 |
| Prepaid expenses and other assets | 7,163 | 6,695 |
| Total current assets | 201,781 | 192,907 |
| Property and equipment, net | 3,994 | 3,621 |
| Capitalized technology and content development costs, net | 26,820 | 22,628 |
| Advance to clients, non-current | 1,350 | 1,042 |
| Prepaid expenses, non-current | 8,123 | 7,099 |
| Other non-current assets | 3,768 | 3,744 |
| Total assets | $ 245,836 | $ 231,041 |
| **Liabilities and stockholders equity** | | |
| Current liabilities: | | |
| Accounts payable | $ 5,588 | $ 4,544 |
| Accrued compensation and related benefits | 9,987 | 13,405 |
| Accrued expenses and other liabilities | 16,916 | 12,039 |
| Deferred revenue | 17,587 | 2,609 |
| Total current liabilities | 50,078 | 32,597 |
| Non-current liabilities | 2,543 | 2,655 |
| Total liabilities | 52,621 | 35,252 |
| Commitments and contingencies (Note 5) | | |
| Stockholders equity: | | |
| Preferred stock, $0.001 par value, 5,000,000 shares authorized, 0 shares issued and outstanding as of June 30, 2016 and December 31, 2015 | | |
| Common stock, $0.001 par value, 200,000,000 shares authorized, 46,632,069 shares issued and outstanding as of June 30, 2016; 45,776,455 shares issued and outstanding as of December 31, 2015 | 47 | 46 |
| Additional paid-in capital | 360,466 | 351,324 |
| Accumulated deficit | (167,298) | (155,581) |
| Total stockholders equity | 193,215 | 195,789 |
| Total liabilities and stockholders equity | $ 245,836 | $ 231,041 |

See accompanying notes to condensed consolidated financial statements.

Table of Contents

**2U, Inc.**

**Condensed Consolidated Statements of Operations**

**(unaudited, in thousands, except share and per share amounts)**

| | Three Months Ended June 30, 2016 | Three Months Ended June 30, 2015 | Six Months Ended June 30, 2016 | Six Months Ended June 30, 2015 |
|---|---|---|---|---|
| Revenue | $ 49,110 | $ 35,238 | $ 96,554 | $ 69,850 |
| Costs and expenses: | | | | |
| Servicing and support | 10,260 | 7,903 | 19,772 | 15,454 |
| Technology and content development | 8,842 | 6,466 | 16,117 | 12,600 |
| Program marketing and sales | 27,483 | 21,526 | 51,139 | 41,113 |
| General and administrative | 10,944 | 8,871 | 21,391 | 15,582 |
| Total costs and expenses | 57,529 | 44,766 | 108,419 | 84,749 |
| Loss from operations | (8,419) | (9,528) | (11,865) | (14,899) |
| Other income (expense): | | | | |
| Interest expense | (9) | (126) | (35) | (252) |
| Interest income | 91 | 24 | 183 | 53 |
| Total other income (expense) | 82 | (102) | 148 | (199) |
| Loss before income taxes | (8,337) | (9,630) | (11,717) | (15,098) |
| Income tax expense | | | | |
| Net loss | $ (8,337) | $ (9,630) | $ (11,717) | $ (15,098) |
| Net loss per share, basic and diluted | $ (0.18) | $ (0.23) | $ (0.25) | $ (0.37) |
| Weighted-average shares of common stock outstanding, basic and diluted | 46,494,464 | 41,362,476 | 46,226,117 | 41,171,669 |

See accompanying notes to condensed consolidated financial statements.

Table of Contents

**2U, Inc.**

**Condensed Consolidated Statement of Changes in Stockholders Equity**

**(unaudited, in thousands, except share amounts)**

| | Common Stock Shares | Common Stock Amount | Additional Paid-In Capital | Accumulated Deficit | Total Stockholders Equity |
|---|---|---|---|---|---|
| Balance, December 31, 2015 | 45,776,455 | $ 46 | $ 351,324 | $ (155,581) | $ 195,789 |
| Exercise of stock options | 509,878 | 1 | 2,155 | | 2,156 |
| Issuance of common stock in connection with settlement of restricted stock units, net of withholdings | 333,028 | | (365) | | (365) |
| Issuance of common stock award, net of withholdings | 12,708 | | (168) | | (168) |
| Stock-based compensation expense | | | 7,520 | | 7,520 |
| Net loss | | | | (11,717) | (11,717) |
| Balance, June 30, 2016 | 46,632,069 | $ 47 | $ 360,466 | $ (167,298) | $ 193,215 |

See accompanying notes to condensed consolidated financial statements.

Table of Contents

**2U, Inc.**

**Condensed Consolidated Statements of Cash Flows**

**(unaudited, in thousands)**

| | Six Months Ended June 30, 2016 | | Six Months Ended June 30, 2015 | |
|---|---|---|---|---|
| **Cash flows from operating activities** | | | | |
| Net loss | $ | (11,717) | $ | (15,098) |
| Adjustments to reconcile net loss to net cash provided by operating activities: | | | | |
| Depreciation and amortization | | 4,526 | | 3,390 |
| Stock-based compensation expense | | 7,520 | | 5,915 |
| Changes in operating assets and liabilities: | | | | |
| Increase in accounts receivable, net | | (4,267) | | (4,043) |
| Decrease (increase) in advance to clients | | 75 | | (875) |
| Increase in prepaid expenses and other current assets | | (645) | | (366) |
| Increase in accounts payable | | 1,044 | | 784 |
| Decrease in accrued compensation and related benefits | | (3,419) | | (1,533) |
| Increase in accrued expenses and other liabilities | | 4,776 | | 8,108 |
| Increase in deferred revenue | | 14,978 | | 11,520 |
| Decrease (increase) in payments to clients | | 1,664 | | (336) |
| Increase in other assets and other liabilities, net | | (3,028) | | (1,424) |
| Net cash provided by operating activities | | 11,507 | | 6,042 |
| **Cash flows from investing activities** | | | | |
| Purchases of property and equipment | | (1,029) | | (589) |
| Capitalized technology and content development cost expenditures | | (7,437) | | (5,949) |
| Other | | (142) | | |
| Net cash used in investing activities | | (8,608) | | (6,538) |
| **Cash flows from financing activities** | | | | |
| Proceeds from exercise of stock options | | 2,156 | | 2,227 |
| Other | | (533) | | (436) |
| Net cash provided by financing activities | | 1,623 | | 1,791 |
| Net increase in cash and cash equivalents | | 4,522 | | 1,295 |
| Cash and cash equivalents, beginning of period | | 183,729 | | 86,929 |
| Cash and cash equivalents, end of period | $ | 188,251 | $ | 88,224 |
| **Supplemental disclosure of non-cash investing and financing activities** | | | | |
| Accrued capital expenditures | $ | 904 | $ | 199 |

See accompanying notes to condensed consolidated financial statements.

Table of Contents

**2U, Inc.**

**Notes to Condensed Consolidated Financial Statements**

**(unaudited)**

## 1. Description of the Business

2U, Inc. (the Company ) was incorporated as 2Tor Inc. in the State of Delaware in April 2008 and changed its name to 2U, Inc. on October 11, 2012. Under long-term agreements, the Company provides an integrated solution comprised of cloud-based software-as-a-service ( SaaS ), fused with technology-enabled services (together, the Platform ), that allows leading colleges and universities to deliver high-quality online degree programs, extending the universities reach and distinguishing their brands. The Company s SaaS technology consists of (i) a comprehensive learning environment ( Online Campus ), which acts as the hub for all student and faculty academic and social interaction, and (ii) operations applications, which provide the content management, admissions application processing, customer relationship management and other functionality necessary to effectively operate the Company s clients programs. The Company also provides a suite of technology-enabled services that support the complete lifecycle of a higher education program, including attracting students, advising prospective students through the admissions application process, providing technical, success coaching and other support, facilitating accessibility to individuals with disabilities, and facilitating in-program field placements.

## 2. Summary of Significant Accounting Policies

***Basis of Presentation and Principles of Consolidation***

The accompanying unaudited condensed consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries and have been prepared in accordance with United States generally accepted accounting principles ( U.S. GAAP ) and include the assets, liabilities, results of operations and cash flows of the Company. All significant intercompany accounts and transactions have been eliminated in consolidation.

***Reclassifications***

Certain prior period amounts in the condensed consolidated balance sheet and condensed consolidated statement of cash flows have been reclassified to conform to the current period s presentation. Prior period working capital amounts in the condensed consolidated statement of cash flows have been reclassified within operating activities. These reclassifications had no impact on net cash provided by operating activities previously reported for the period. Within the condensed consolidated balance sheet, capitalized technology costs have been reclassified out of property and equipment and have been aggregated with capitalized content development costs, as capitalized technology and content development costs, net, and the notes thereto.

***Unaudited Condensed Consolidated Financial Information***

The accompanying unaudited condensed consolidated financial statements and accompanying notes have been prepared in accordance with U.S. GAAP. The Company has condensed or omitted certain information and footnote disclosures normally included in financial statements presented in accordance with U.S. GAAP in the accompanying unaudited condensed consolidated financial statements. In the opinion of management, the interim financial information includes all adjustments of a normal recurring nature necessary for a fair presentation of financial position, the results of operations, changes in stockholders equity and cash flows, and the disclosures made herein are adequate to prevent the information presented from being misleading. The results of operations for the three and six months ended June 30, 2016 are not necessarily indicative of the results for the full year ending December 31, 2016 or the results for any future periods. These unaudited condensed consolidated interim financial statements should be read in conjunction with the audited consolidated financial statements and related notes for the year ended December 31, 2015, which are included in the Company s Annual Report on Form 10-K filed with the Securities and Exchange Commission (the SEC ) on March 10, 2016.

***Use of Estimates***

The preparation of financial statements in accordance with U.S. GAAP requires management to make certain estimates and assumptions that affect the amounts reported in the condensed consolidated financial statements and accompanying notes. On an ongoing basis, the Company evaluates its estimates, including those related to the useful lives of long-lived assets, fair value measurements and income taxes, among others. The Company bases its estimates and assumptions on historical experience and on various other factors that it believes to be reasonable under the circumstances. Due to the inherent uncertainty involved in making estimates, actual results reported in future periods may be affected by changes in those estimates. The Company evaluates its estimates and assumptions on an ongoing basis.

Table of Contents

***Concentration of Credit Risk***

Financial instruments that subject the Company to significant concentrations of credit risk consist primarily of cash and cash equivalents and accounts receivable. All of the Company s cash is held at financial institutions that management believes to be of high credit quality. The Company s bank accounts exceed federally insured limits at times. The Company has not experienced any losses on cash to date. To manage accounts receivable risk, the Company maintains an allowance for doubtful accounts, if needed.

During the three months ended June 30, 2016, three clients each accounted for 10% or more of the Company s revenue, as follows: $17.6 million, $9.1 million and $5.1 million, which equals 36%, 18% and 10% of total revenue, respectively. During the three months ended June 30, 2015, four clients each accounted for 10% or more of the Company s revenue, as follows: $15.9 million, $5.9 million, $4.0 million and $3.4 million, which equals 45%, 17%, 11% and 10% of total revenue, respectively.

During the six months ended June 30, 2016, three clients each accounted for 10% or more of the Company s revenue, as follows: $35.5 million, $16.9 million and $10.2 million, which equals 37%, 17% and 11% of total revenue, respectively. During the six months ended June 30, 2015, four clients each accounted for 10% or more of the Company s revenue, as follows: $33.4 million, $10.3 million, $8.3 million and $6.8 million, which equals 48%, 15%, 12% and 10% of total revenue, respectively.

Additionally, the Company s largest client accounted for 79% and 7% of the Company s accounts receivable balance as of June 30, 2016 and December 31, 2015, respectively. No additional clients accounted for more than 10% of the Company s accounts receivable balance as of June 30, 2016, while one additional client accounted for more than 10% of the Company s accounts receivable balance as of December 31, 2015.

***Long-Lived Assets***

*Property and Equipment*

Property and equipment is stated at cost less accumulated depreciation and amortization. Expenditures for major additions, construction and improvements are capitalized. Depreciation and amortization is expensed using the straight-line method over the estimated useful lives of the related assets, which range from three to five years for computer hardware and five to seven years for furniture and office equipment. Leasehold improvements are depreciated on a straight-line basis over the lesser of the remaining term of the leased facility or the estimated useful life of the improvement, which ranges from four to ten years. Useful lives of significant assets are periodically reviewed and adjusted prospectively to reflect the Company s current estimates of the respective assets expected utility. Repair and maintenance costs are expensed as incurred.

*Capitalized Technology and Content Development Costs*

The Company capitalizes certain costs related to internal-use software, primarily consisting of direct labor associated with creating the software. Software development projects generally include three stages: the preliminary project stage (all costs are expensed as incurred), the application development stage (certain costs are capitalized and certain costs are expensed as incurred) and the post-implementation/operation stage (all costs are expensed as incurred). Costs capitalized in the application development stage include costs of designing the application, coding, integrating the Company s and the university s networks and systems, and the testing of the software. Capitalization of costs requires judgment in determining when a project has reached the application development stage and the period over which the Company expects to benefit from the use of that software. Once the software is placed in service, these costs are amortized on the straight-line method over the estimated useful life of the software, which is generally three years.

The Company works with each client s faculty members to develop and maintain educational content that is delivered to their students through Online Campus. The online content developed jointly by the Company and its clients consists of subjects chosen and taught by clients faculty members and incorporates references and examples designed to remain relevant over extended periods of time. Online delivery of the content, combined with live, face-to-face instruction, provides the Company with rapid user feedback that it uses to make ongoing corrections, modifications and improvements to the course content. The Company s clients retain all intellectual property rights to the developed content, although the Company retains the rights to the content packaging and delivery mechanisms.

Much of the Company s new content development uses proven delivery platforms and is therefore primarily subject-specific in nature. As a result, a significant portion of content development costs qualify for capitalization due to the focus of the Company s development efforts on the unique subject matter of the content. Similar to on-campus programs offered by the Company s clients, the online degree programs enabled by the Company offer numerous courses for each degree. The Company therefore capitalizes its development costs on a course-by-course basis. As students must matriculate into a client program in order to take a course, revenues and identifiable cash flows are also measured at the client program level.

The Company develops content on a course-by-course basis in conjunction with the faculty for each client program. The clients and their faculty generally provide course outlines in the form of the curriculum, required textbooks, case studies and other reading materials, as well as presentations that are typically used in the on-campus setting. The Company is then responsible for, and incurs all of the expenses related to, the conversion of the materials provided by each client into a format suitable for delivery through Online Campus.

The content development costs that qualify for capitalization are third-party direct costs, such as videography, editing and other services associated with creating digital content. Additionally, the Company capitalizes internal payroll and payroll-related costs incurred to create and produce videos and other digital content utilized in the clients programs for delivery via Online Campus. Capitalization ends when content has been fully developed by both the Company and the client, at which time amortization of the capitalized content development costs begins. The capitalized costs are recorded on a course-by-course basis and included in capitalized content costs on the condensed consolidated balance sheets. These costs are amortized using the straight-line method over the estimated useful life of the respective capitalized content program, which is generally five years. The estimated useful life corresponds with the Company s planned curriculum refresh rate. This refresh rate is consistent with expected curriculum refresh rates as cited by program faculty members for similar on-campus programs. It is reasonably possible that developed content could be refreshed before the estimated useful lives are complete or be expensed immediately in the event that the development of a course is discontinued prior to launch.

*Evaluation of Long-Lived Assets*

The Company reviews long-lived assets, which consist of property and equipment, capitalized technology costs, capitalized content development costs and acquired finite-lived intangible assets, for impairment whenever events or changes in circumstances indicate the carrying value of an asset may not be recoverable. Recoverability of a long-lived asset is measured by a comparison of the carrying value of an asset or asset group to the future undiscounted net cash flows expected to be generated by that asset or asset group. If such assets are not recoverable, the impairment to be recognized is measured by the amount by which the carrying value of an asset exceeds the estimated fair value (discounted cash flow) of the asset or asset group. In order to assess the recoverability of the capitalized content development costs, the costs are grouped by program, which is the lowest level of independent cash flows. The Company s impairment analysis is based upon forecasted financial and operational results. The actual results could vary from the Company s forecasts, especially in relation to recently launched programs. For the three and six months ended June 30, 2016 and 2015, no impairment of long-lived assets was deemed to have occurred.

***Revenue Recognition and Deferred Revenue***

The Company recognizes revenue when all of the following conditions are met: (i) persuasive evidence of an arrangement exists, (ii) rendering of services is complete, (iii) fees are fixed or determinable and (iv) collection of fees is reasonably assured.

The Company primarily derives its revenue from long-term contracts that typically range from 10 to 15 years in length. Under these contracts, the Company enables access to its Platform to its clients and their faculty and students. The Company is entitled to a contractually specified percentage of net program proceeds from its clients. These net program proceeds represent gross proceeds billed by clients to students, less credit card fees and other specified charges the Company has agreed to exclude in certain of its client contracts.

The Company generates substantially all of its revenue from multiple-deliverable contractual arrangements with its clients. Under each of these arrangements, the Company provides (i) access to Online Campus, which serves as a learning platform for its client s faculty and students and which also enables a comprehensive range of other client functions, (ii) access to operations applications which provide the content management, admissions application processing, customer relationship management, and other functionality necessary to effectively operate the Company s clients programs and (iii) technology-enabled services that support the complete lifecycle of a higher education program, including attracting students, advising prospective students through the admissions application process, providing technical, success coaching and other support, facilitating accessibility to individuals with disabilities, and facilitating in-program field placements.

Table of Contents

In order to treat deliverables in a multiple-deliverable contractual arrangement as separate units of accounting, deliverables must have standalone value upon delivery. The technology-enabled services within the Platform are provided primarily in support of programs delivered through Online Campus, and for students of the programs delivered through Online Campus. Accordingly, the Company has determined that no individual deliverable has standalone value upon delivery and, therefore, deliverables within the Company s multiple-deliverable arrangements do not qualify for treatment as separate units of accounting. Therefore, the Company considers all deliverables to be a single unit of accounting and recognizes revenue from the entire arrangement over the term of the service period.

Advance payments are recorded as deferred revenue until services are delivered or obligations are met, at which time revenue is recognized. Deferred revenue as of a particular balance sheet date represents the excess of amounts received as compared to amounts recognized in revenue in the condensed consolidated statements of operations as of the end of the reporting period, and such amounts are reflected as a current liability on the Company s condensed consolidated balance sheets.

***Stock-Based Compensation***

The Company accounts for stock-based compensation awards based on the fair value of the award as of the grant date. For awards subject to service-based vesting conditions, the Company recognizes stock-based compensation expense on a straight-line basis over the awards requisite service period, adjusted for estimated forfeitures. For awards subject to both performance and service-based vesting conditions, the Company recognizes stock-based compensation expense using an accelerated recognition method when it is probable that the performance condition will be achieved.

See Note 7 for a summary of assumptions used in calculating the fair value of stock options.

***Comprehensive Loss***

The Company s net loss equals comprehensive loss for all periods presented as the Company has no material components of other comprehensive income.

***Recent Accounting Pronouncements***

In March 2016, the Financial Accounting Standards Board ( FASB ) issued Accounting Standards Update ( ASU ) No. 2016-09, *Compensation Stock Compensation*. The ASU simplifies various aspects related to the accounting and presentation of share-based payments. The guidance also allows employers to withhold shares to satisfy minimum statutory withholding requirements up to the employees maximum individual tax rate without causing the award to be classified as a liability. Additionally, the guidance stipulates that cash paid by an employer to a taxing authority when directly withholding shares for tax withholding purposes should be classified as a financing activity on the statement of cash flows. The amendments in this ASU are effective for fiscal years beginning after December 15, 2016. Early adoption is permitted in any interim or annual period, with any adjustments reflected as of the beginning of the fiscal year of adoption. The Company is currently evaluating the effect that this standard will have on its consolidated financial position and related disclosures.

In February 2016, the FASB issued ASU No. 2016-02, *Leases*. The ASU introduces a model for lessees requiring most leases to be reported on the balance sheet. Lessor accounting remains substantially similar to current U.S. GAAP. The amendments in this ASU are effective for fiscal years beginning after December 15, 2018. The Company is currently evaluating the effect that this standard will have on its consolidated financial position and related disclosures.

In November 2015, the FASB issued ASU No. 2015-17, *Balance Sheet Classification of Deferred Taxes*. The ASU eliminates the requirement to classify deferred tax assets and liabilities between current and noncurrent. The ASU requires classification of all deferred tax asset and liability balances as noncurrent. The amendments in this ASU are effective for fiscal years beginning after December 15, 2016, with early adoption permitted. Adoption of the ASU is either retrospective to each prior period presented, or prospective. As of December 31, 2015, the Company early adopted the ASU prospectively. Adoption of this standard did not have a material impact on the Company s consolidated financial position and related disclosures.

In April 2015, the FASB issued ASU No. 2015-05, *Intangibles Goodwill and Other Internal-Use Software*. The ASU provides guidance to customers in a cloud computing arrangement to determine whether the arrangement includes a software license. When a cloud computing arrangement includes a software license, the customer is required to account for the license element of the arrangement consistent with the acquisition of other software licenses. The amendments in this ASU are effective for fiscal years beginning after December 15, 2015. The Company adopted this ASU on January 1, 2016. Adoption of this standard did not have a material impact on the Company s consolidated financial position and related disclosures.

Table of Contents

In April 2015, the FASB issued ASU No. 2015-03, *Interest Imputation of Interest*. The ASU simplifies the presentation of debt issuance costs by requiring that such costs be presented in the consolidated balance sheets as a direct deduction from the carrying value of the associated debt instrument, consistent with debt discounts. Subsequent to the issuance of this ASU, the SEC staff announced that the presentation of debt issuance costs associated with line-of-credit arrangements may be presented as an asset. This announcement was codified by the FASB in ASU 2015-15. The amendments in these ASUs are effective for fiscal years beginning after December 15, 2015. The Company adopted this ASU on January 1, 2016. Adoption of this standard did not have a material impact on the Company s consolidated financial position and related disclosures.

In January 2015, the FASB issued ASU No. 2015-01, *Income Statement Extraordinary and Unusual Items*. The ASU simplifies income statement presentation by eliminating the concept of extraordinary items. The amendments in this ASU are effective for fiscal periods beginning after December 15, 2015. The Company adopted this ASU on January 1, 2016. Adoption of this standard did not have a material impact on the Company s consolidated financial position and related disclosures.

In August 2014, the FASB issued ASU No. 2014-15, *Disclosure of Uncertainties about an Entity s Ability to Continue as a Going Concern*. The ASU requires that an entity s management evaluate whether there are conditions or events that raise substantial doubt about the entity s ability to continue as a going concern within one year after the date that the financial statements are issued. The amendments in this ASU are effective for annual reporting periods ending after December 15, 2016. The Company does not expect the new standard to have a significant impact on its reporting process.

In May 2014, the FASB issued ASU No. 2014-09, *Revenue from Contracts with Customers*, which requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. The ASU will replace most existing revenue recognition guidance in U.S. GAAP when it becomes effective. In July 2015, the FASB deferred the mandatory effective date of this ASU by one year from January 1, 2017 to January 1, 2018. Early application is permitted, but not prior to the original effective date of January 1, 2017. The standard permits the use of either the retrospective or cumulative effect transition method. The Company is currently evaluating the effect that this standard will have on its consolidated financial position and related disclosures. The Company has not yet selected a transition method nor has it determined the effect of the standard on its ongoing financial reporting.

## 3. Property and Equipment

Property and equipment consisted of the following as of:

| | June 30, 2016 | December 31, 2015 |
|---|---|---|
| | (in thousands) | |
| Computer hardware | $ 3,180 | $ 2,911 |
| Furniture and office equipment | 1,722 | 1,666 |
| Leasehold improvements | 1,846 | 1,837 |
| Leasehold improvements in process | 823 | |
| Total | 7,571 | 6,414 |
| Accumulated depreciation and amortization | (3,577) | (2,793) |

| | | | | |
|---|---|---|---|---|
| Property and equipment, net | $ | 3,994 | $ | 3,621 |

Depreciation and amortization expense of property and equipment was $0.4 million and $0.3 million for the three months ended June 30, 2016 and 2015, respectively. Depreciation and amortization expense of property and equipment was $0.8 million and $0.5 million for the six months ended June 30, 2016 and 2015, respectively.

As of June 30, 2016, the estimated future depreciation and amortization expense for property and equipment placed in service is as follows (in thousands):

| | | |
|---|---|---|
| 2016 | $ | 786 |
| 2017 | | 974 |
| 2018 | | 753 |
| 2019 | | 449 |
| 2020 | | 185 |
| Thereafter | | 24 |
| Total | $ | 3,171 |

Table of Contents

## 4. Capitalized Technology and Content Development Costs

Capitalized technology and content development costs consisted of the following as of:

| | June 30, 2016 | | | December 31, 2015 | | |
|---|---|---|---|---|---|---|
| | Gross Carrying Amount | Accumulated Amortization | Net Carrying Amount | Gross Carrying Amount | Accumulated Amortization | Net Carrying Amount |
| | (in thousands) | | | | | |
| Capitalized technology costs | $ 10,585 | $ (6,681) | $ 3,904 | $ 8,564 | $ (5,697) | $ 2,867 |
| Capitalized technology costs in process | 2,356 | | 2,356 | 1,640 | | 1,640 |
| Total capitalized technology costs | 12,941 | (6,681) | 6,260 | 10,204 | (5,697) | 4,507 |
| | | | | | | |
| Capitalized content development costs | 29,843 | (13,404) | 16,439 | 24,796 | (10,931) | 13,865 |
| Capitalized content development costs in process | 4,121 | | 4,121 | 4,256 | | 4,256 |
| Total capitalized content development costs | 33,964 | (13,404) | 20,560 | 29,052 | (10,931) | 18,121 |
| Capitalized technology and content development costs, net | $ 46,905 | $ (20,085) | $ 26,820 | $ 39,256 | $ (16,628) | $ 22,628 |

Amortization expense related to capitalized technology was $0.5 million and $0.4 million for the three months ended June 30, 2016 and 2015, respectively. Amortization expense related to capitalized technology was $1.0 million and $0.8 million for the six months ended June 30, 2016 and 2015, respectively. This expense is included in technology and content development costs in the accompanying condensed consolidated statements of operations.

The Company recorded amortization expense related to capitalized content development costs of $1.4 million and $1.0 million for the three months ended June 30, 2016 and 2015, respectively. The Company recorded amortization expense related to capitalized content development costs of $2.6 million and $2.1 million for the six months ended June 30, 2016 and 2015, respectively.

As of June 30, 2016, the estimated future amortization expense for the capitalized technology and content development costs placed in service is as follows (in thousands):

| | |
|---|---|
| 2016 | $ 3,502 |
| 2017 | 6,423 |
| 2018 | 5,211 |
| 2019 | 3,336 |

| | | |
|---|---|---|
| 2020 | | 1,705 |
| Thereafter | | 166 |
| Total | $ | 20,343 |

## 5. Commitments and Contingencies

***Line of Credit***

On December 31, 2013, the Company entered into a credit agreement for a revolving line of credit with an aggregate borrowing commitment not to exceed $37.0 million. On December 31, 2015, the Company amended this credit agreement to reduce the aggregate amount it may borrow to $25.0 million and on July 26, 2016, the Company amended this credit agreement to extend the maturity date through October 1, 2016. No amounts were outstanding as of June 30, 2016 or December 31, 2015.

In connection with the Company entering into an operating lease agreement on December 23, 2015, to lease its new office facility in Lanham, Maryland, the Company entered into a standby letter of credit on January 22, 2016 in the amount of $6.0 million as a security deposit for the new leased facilities. In connection with the Company entering into an operating lease agreement on May 11, 2016, to lease its new office facility in Denver, Colorado, the Company entered into a standby letter of credit on June 14, 2016 in the

Table of Contents

amount of $1.1 million as a security deposit for the new leased facilities. These letters of credit reduced the aggregate amount the Company may borrow under its revolving line of credit to $17.9 million.

Under this revolving line of credit, the Company has the option of borrowing funds subject to (i) a base rate, which is equal to 1.5% plus the greater of Comerica Bank s prime rate, the federal funds rate plus 1% or the 30 day LIBOR plus 1%, or (ii) LIBOR plus 2.5%. For amounts borrowed under the base rate, the Company may make interest-only payments quarterly, and may prepay such amounts with no penalty. For amounts borrowed under LIBOR, the Company makes interest-only payments in periods of one, two and three months and will be subject to a prepayment penalty if such borrowed amounts are repaid before the end of the interest period.

Borrowings under the line of credit are collateralized by substantially all of the Company s assets. The availability of borrowings under this credit line is subject to compliance with reporting and financial covenants, including, among other things, that the Company achieves specified minimum three-month trailing revenue levels during the term of the agreement and specified minimum six-month trailing profitability levels for some client programs, measured quarterly. In addition, the Company is required to maintain a minimum adjusted quick ratio, which measures short-term liquidity, of at least 1.10 to 1.00. As of June 30, 2016 and December 31, 2015, the Company s adjusted quick ratio was 7.95 and 7.90, respectively.

The covenants under the line of credit also place limitations on the Company s ability to incur additional indebtedness or to prepay permitted indebtedness, grant liens on or security interests in its assets, carry out mergers and acquisitions, dispose of assets, declare, make or pay dividends, make capital expenditures in excess of specified amounts, make investments, loans or advances, enter into transactions with affiliates, amend or modify the terms of material contracts, or change its fiscal year. If the Company is not in compliance with the covenants under the line of credit, after any opportunity to cure such non-compliance, or it otherwise experiences an event of default under the line of credit, the lenders may require repayment in full of all principal and interest outstanding. If the Company fails to repay such amounts, the lenders could foreclose on the assets pledged as collateral under the line of credit. The Company is currently in compliance with all such covenants.

***Legal Contingencies***

From time to time, the Company may become involved in legal proceedings or other contingencies in the ordinary course of its business. The Company is not presently involved in any legal proceeding or other contingency that, if determined adversely to it, would individually or in the aggregate have a material adverse effect on its business, operating results, financial condition or cash flows. Accordingly, the Company does not believe that there is a reasonable possibility that a material loss exceeding amounts already recognized may have been incurred as of the date of the balance sheets presented herein.

***Program Marketing and Sales Commitments***

Certain of the agreements entered into between the Company and its clients require the Company to commit to meet certain staffing and spending investment thresholds related to program marketing and sales activities. In addition, certain of the agreements require the Company to invest up to agreed-upon levels in marketing the programs to achieve specified program performance. The Company believes it is currently in compliance with all such commitments.

***Operating Leases***

The Company leases office facilities under non-cancelable operating leases in Maryland, New York, California, Colorado, North Carolina, Virginia and Hong Kong. The Company also leases office equipment under non-cancelable leases. As of June 30, 2016, the future minimum lease payments (net of aggregate expected sublease payments of $0.2 million) were as follows (in thousands):

| | | |
|---|---|---|
| 2016 | $ | 2,187 |
| 2017 | | 6,228 |
| 2018 | | 7,702 |
| 2019 | | 8,186 |
| 2020 | | 7,952 |
| Thereafter | | 64,765 |
| Total future minimum lease payments | $ | 97,020 |

The future minimum lease payments due under non-cancelable operating lease arrangements contain fixed rent increases over the term of the lease. Rent expense on these operating leases is recognized over the term of the lease on a straight-line basis. The excess of rent expense over future minimum lease payments due has been reported in non-current liabilities in the accompanying condensed consolidated balance sheets. The deferred rent liability related to these leases totaled $0.7 million and $0.6 million as of June 30, 2016 and December 31, 2015, respectively.

Table of Contents

Total rent expense from non-cancelable operating lease agreements was $1.1 million (net of sublease income of $0.1 million) for the three months ended June 30, 2016, and $0.8 million (net of sublease income of $0.1 million) for the three months ended June 30, 2015. Total rent expense from non-cancelable operating lease agreements was $2.1 million (net of sublease income of $0.1 million) for the six months ended June 30, 2016, and $1.4 million (net of sublease income of $0.1 million) for the six months ended June 30, 2015.

***Fixed Payments to Clients***

The Company is contractually obligated to make fixed payments to certain of its clients in exchange for contract extensions and various marketing and other rights. Currently, the future minimum fixed payments to the Company s clients in exchange for contract extensions and various marketing and other rights were as follows (in thousands):

| | | |
|---|---|---|
| 2016 | $ | 573 |
| 2017 | | 4,478 |
| 2018 | | 3,875 |
| 2019 | | 875 |
| 2020 | | 625 |
| Thereafter | | 5,650 |
| Total future minimum program payments | $ | 16,076 |

***Contingent Payments to Clients***

The Company has entered into specific program agreements under which it would be obligated to make future minimum program payments to a client in the event that certain program metrics, partially associated with programs not yet launched, are not achieved. Due to the dependency of these calculations on future program launches, the amounts of any associated contingent payments cannot be reasonably estimated at this time. As the Company cannot reasonably estimate the amounts of the contingent payments, and because it believes any contingent payments under this agreement would likely be immaterial, the Company has excluded such payments from the table above.

## 6. Stockholders Equity

As of June 30, 2016, the Company was authorized to issue 205,000,000 total shares of capital stock, consisting of 200,000,000 shares of common stock and 5,000,000 shares of preferred stock. At June 30, 2016, the Company had reserved a total of 9,856,900 of its authorized shares of common stock for future issuance as follows:

| | |
|---|---|
| Outstanding stock options | 5,358,182 |
| Possible future issuance under 2014 Plan | 3,077,346 |
| Outstanding restricted stock units | 1,421,372 |
| Total shares of common stock reserved for future issuance | 9,856,900 |

The compensation committee of the Company s board of directors, acting under authority delegated from the board of directors, granted on July 1, 2016 option awards to employees and an independent director to purchase an aggregate of 8,914 shares of common stock at an exercise price of $29.53 and restricted stock unit awards for an aggregate of 21,260 shares of common stock, in each case under the 2014 Equity Incentive Plan (as defined in Note 7 below).

## 7. Stock-Based Compensation

The Company provides equity-based compensation awards to employees, independent contractors and directors as an effective means for attracting, retaining and motivating such individuals. The Company maintains two share-based compensation plans: the 2014 Equity Incentive Plan (the 2014 Plan ) and the 2008 Stock Incentive Plan (the 2008 Plan ). Upon the effective date of the 2014 Plan in January 2014, the Company ceased using the 2008 Plan to grant new equity awards and began using the 2014 Plan for grants of new equity awards.

The number of shares of the Company s common stock that may be issued under the 2014 Plan will automatically increase on January 1st of each year, for a period of ten years, from January 1, 2015 continuing through January 1, 2024, by 5% of the total number of shares of the Company s common stock outstanding on December 31st of the preceding calendar year, or a lesser number of shares as may be determined by the Company s board of directors. The shares available for issuance increased by 2,288,820 and 2,036,503 on January 1, 2016 and 2015, respectively, pursuant to the automatic share reserve increase provision under the 2014 Plan.

Table of Contents

***Stock-Based Compensation Expense***

Stock-based compensation expense related to stock-based awards is included in the following line items in the accompanying condensed consolidated statements of operations:

| | Three Months Ended June 30, 2016 | Three Months Ended June 30, 2015 | Six Months Ended June 30, 2016 | Six Months Ended June 30, 2015 |
|---|---|---|---|---|
| | (in thousands) | | | |
| Servicing and support | $ 923 | $ 607 | $ 1,574 | $ 995 |
| Technology and content development | 654 | 427 | 1,106 | 658 |
| Program marketing and sales | 355 | 277 | 613 | 459 |
| General and administrative | 2,044 | 2,556 | 4,227 | 3,803 |
| Total stock-based compensation expense | $ 3,976 | $ 3,867 | $ 7,520 | $ 5,915 |

***Stock Options***

The following table summarizes the assumptions used for estimating the fair value of the stock options granted for the periods presented.

| | Three Months Ended June 30, 2016 | Three Months Ended June 30, 2015 | Six Months Ended June 30, 2016 | Six Months Ended June 30, 2015 |
|---|---|---|---|---|
| Risk-free interest rate | 1.3% 1.4% | 1.5 1.9% | 1.3% 1.9% | 1.5% 1.9% |
| Expected term (years) | 5.75 6.08 | 6.00 6.08 | 5.75 6.08 | 5.83 6.08 |
| Expected volatility | 50% | 50% | 50% | 50% |
| Dividend yield | 0% | 0% | 0% | 0% |
| Weighted-average grant date fair value per share | $11.01 | $12.51 | $11.02 | $12.42 |

The following is a summary of the stock option activity for the six months ended June 30, 2016:

| | Number of Options | Weighted-Average Exercise Price per Share | Weighted-Average Remaining Contractual Term (in years) | Aggregate Intrinsic Value (in thousands) |
|---|---|---|---|---|
| Outstanding balance at December 31, 2015 | 5,298,510 | $ 8.07 | 6.66 | $ 105,595 |
| Granted | 712,286 | 22.72 | 9.56 | |
| Exercised | (509,878) | 4.27 | 1.61 | |
| Forfeited | (142,736) | 19.99 | | |
| Outstanding balance at June 30, 2016 | 5,358,182 | 10.06 | 6.59 | 103,716 |
| Exercisable at June 30, 2016 | 3,534,756 | 5.85 | 5.56 | 83,290 |
| Vested and expected to vest at June 30, 2016 | 5,197,319 | 9.73 | 6.52 | 102,306 |

The total compensation cost related to the nonvested options not yet recognized as of June 30, 2016 was $14.3 million and will be recognized over a weighted-average period of approximately 2.3 years.

The aggregate intrinsic value of the options exercised during the six months ended June 30, 2016 and 2015 was $10.5 million and $14.0 million, respectively.

***Restricted Stock Units***

The following is a summary of restricted stock unit activity for the three months ended June 30, 2016:

| | Number of Restricted Stock Units | | Weighted-Average Grant Date Fair Value |
|---|---|---|---|
| Outstanding balance at December 31, 2015 | 1,220,008 | $ | 17.97 |
| Granted | 665,084 | | 22.75 |
| Vested | (350,681) | | 16.76 |
| Forfeited | (113,039) | | 20.05 |
| Outstanding balance at June 30, 2016 | 1,421,372 | | 20.34 |

Table of Contents

The total compensation cost related to the nonvested restricted stock units not yet recognized as of June 30, 2016 was $22.5 million and will be recognized over a weighted-average period of approximately 2.8 years.

## 8. Net Loss per Share

Diluted net loss per share is the same as basic net loss per share for all periods presented because the effects of potentially dilutive items were anti-dilutive, given the Company s net loss. The following securities have been excluded from the calculation of weighted-average shares of common stock outstanding because the effect is anti-dilutive for the three and six months ended June 30, 2016 and 2015:

| | Three and Six Months Ended June 30, | |
|---|---|---|
| | **2016** | **2015** |
| Stock options | 5,358,182 | 5,958,578 |
| Restricted stock units | 1,421,372 | 1,236,153 |

Basic and diluted net loss per share is calculated as follows:

| | Three Months Ended June 30, | | | | Six Months Ended June 30, | | | |
|---|---|---|---|---|---|---|---|---|
| | | **2016** | | **2015** | | **2016** | | **2015** |
| Numerator (in thousands): | | | | | | | | |
| Net loss | $ | (8,337) | $ | (9,630) | $ | (11,717) | $ | (15,098) |
| Denominator: | | | | | | | | |
| Weighted-average shares of common stock outstanding, basic and diluted | | 46,494,464 | | 41,362,476 | | 46,226,117 | | 41,171,669 |
| Net loss per share, basic and diluted | $ | (0.18) | $ | (0.23) | $ | (0.25) | $ | (0.37) |

## 9. Segment and Geographic Information

Operating segments are defined as components of an enterprise for which discrete financial information is available that is evaluated regularly by the chief operating decision maker ( CODM ) for purposes of allocating resources and evaluating financial performance. The Company s CODM reviews the financial information presented on a consolidated basis for purposes of allocating resources and evaluating financial performance. As such, the Company s operations constitute a single operating segment and one reportable segment. The Company offers similar services to substantially all of its clients, which primarily represent well-recognized nonprofit colleges and universities in the United States. Substantially all assets were held and all revenue was generated in the United States during all periods presented.

## 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 condensed consolidated financial statements and the related notes to those statements included elsewhere in this Quarterly Report on Form 10-Q and our Annual Report on Form 10-K for the year ended December 31, 2015. Certain statements contained in this Quarterly Report on Form 10-Q may constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934 (the Exchange Act ), as amended. The words or phrases would be, will allow, intends to, will likely result, are expected to, will continue, is anticipated, estimate, project, or similar expressions, or the negative of such words or phrases, are intended to identify forward-looking statements. We have based these forward-looking statements on our current expectations and projections about future events. Because such statements include risks and uncertainties, actual results may differ materially from those expressed or implied by such forward-looking statements. Many factors could cause or contribute to these differences, including those discussed in Part I, Item 1A, Risk Factors, in our Annual Report on Form 10-K for the year ended December 31, 2015, and our other filings with the Securities and Exchange Commission, or SEC. Statements made herein are as of the date of the filing of this Form 10-Q with the SEC and should not be relied upon as of any subsequent date. Unless otherwise required by applicable law, we do not undertake, and we specifically disclaim, any obligation to update any forward-looking statements to reflect occurrences, developments, unanticipated events or circumstances after the date of such statement.*

Table of Contents

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our unaudited condensed consolidated financial statements and related notes that appear in Item 1 of this Quarterly Report on Form 10-Q and with our audited consolidated financial statements and related notes for the year ended December 31, 2015, which are included in our Annual Report on Form 10-K filed with the SEC on March 10, 2016.

**Overview**

We are a leading provider of an integrated solution comprised of cloud-based software-as-a-service, or SaaS, technology fused with technology-enabled services, which we refer to as our Platform. Our Platform enables leading nonprofit colleges and universities to deliver their high-quality education to qualified students anywhere. Our SaaS technology consists of an innovative online learning environment, which we refer to as Online Campus, and our operations applications. This technology is fused with technology-enabled services, to complete our Platform. Our Platform allows our clients programs to expand and operate at scale, providing the comprehensive infrastructure colleges and universities need to attract, enroll, educate, support and graduate their students. By leveraging our Platform, we believe our clients are able to expand their addressable markets while providing educational engagement, experiences and outcomes to their online students that match or exceed those of their on-campus offerings.

**Our Business Model**

The key elements of our business model are described below.

***Revenue Drivers and Predictability***

Substantially all of our revenue is derived from revenue-share arrangements with our clients, under which we receive a contractually specified percentage of the amounts students pay them in tuition and other fees. Accordingly, the primary driver of our revenue growth is the increase in the number of student course enrollments in our clients programs. This in turn is influenced primarily by three factors:

- our ability to increase the number of programs offered by our clients, either by adding new clients or by expanding the number of client programs;
- our ability to identify and acquire prospective students for our clients programs; and
- our ability, and that of our clients, to retain the students who enroll in their programs.

In the near term, we expect the primary drivers of our financial results to continue to be our two programs with the University of Southern California, which are our longest running programs, which we launched in 2009 and 2010. For the three months ended June 30, 2016 and 2015, 36% and 45%, respectively, of our revenue was derived from these two programs, while for the six months ended June 30, 2016 and 2015, 37% and 48%, respectively, of our revenue was derived from these two programs. We expect the University of Southern California will continue to account for a large portion of our revenue even though that portion will likely continue to decline as other client programs become more mature and achieve higher enrollment levels.

A significant percentage of our revenue in any period is related to students returning to our clients programs after their first academic term. We believe this contributes to the predictability and recurring nature of our business.

***Program Marketing and Sales Expense***

Our most significant expense in each fiscal period has been program marketing and sales expense, which relates primarily to student acquisition activities. We do not spend significant amounts on new client or program acquisition and we do not maintain a sales force targeted at potential new clients or programs since our model is not dependent on launching a large number of new programs per year, either with new or existing clients. Instead, our new clients and programs are largely generated through a direct approach by our senior management to selected colleges and universities.

We have primary responsibility for identifying qualified students for our clients programs, generating potential student interest in the programs and driving applications to the programs. While our clients make all admissions decisions, the number of students who enroll in our clients programs in any given period is significantly dependent on the amount we have spent on these student acquisition activities in prior periods. Accordingly, although most of our clients programs span multiple academic terms and, therefore, generate continued revenue beyond the term in which initial enrollments occur, we expect that we will need to continue to incur significant

Table of Contents

program marketing and sales expense for existing programs going forward to generate a continuous pipeline of new enrollments. For new programs, we begin incurring program marketing and sales costs as early as nine months prior to the start of a new client program.

We typically identify prospective students for our clients programs between three months and two or more years before they ultimately enroll. For the students currently enrolled in our clients programs and those who have graduated, the average time from our initial prospective student acquisition to initial enrollment was seven months. For the students who have graduated from these programs, the average time from initial enrollment to graduation was 22 months. Based on the student retention rates and patterns we have observed in our clients programs, we estimate that, for our current programs, the average time from a student s initial enrollment to graduation will be approximately two years.

Accordingly, our program marketing and sales expense in any period is an investment we make to generate revenue in future periods. Likewise, revenue generated in any period is largely attributable to the investment made in student acquisition activities in earlier periods. Because program marketing and sales expense in any period is almost entirely unrelated to revenue generated in that period, we do not believe it is meaningful to directly compare the two. We believe that the total revenue we will receive in the future from students who enroll in our clients programs as a result of current period program marketing and sales expense will be significantly greater as a multiple of that expense than is implied by the multiple of current period revenue to current period program marketing and sales expense. Further, we believe that our program marketing and sales expense in future periods will generally decline as a percentage of the revenue reported in those same periods as our revenue base from returning students in existing programs increases.

We continually manage our program marketing and sales expense to ensure that across our portfolio of client programs, our cost to acquire students for these programs is appropriate for our business model. We use a ratio of attrition adjusted lifetime revenue of a student, or LTR, to the total cost to acquire that student, or TCA, as the measure of our marketing efficiency and to determine how much we are willing to spend to acquire an additional student for any program. The calculations included in this ratio include certain assumptions. For any period, we know what we spent on program sales and marketing and therefore, can accurately calculate the ratio s denominator. However, given the time lag between when we incur our program marketing and sales expense and when we receive revenue related to students enrolled based on that expense, we have to incorporate forecasts of student enrollments and retention into our calculation of the ratio s numerator, which is our estimate of future revenue related to that period s expense. We use the significant amount of data we have on the effectiveness of various marketing channels, student attrition and other factors to inform our forecasts and are continually testing the assumptions underlying these forecasts against actual results to give us confidence that our forecasts are reasonable. The LTR to TCA ratio may vary from program to program depending on the degree being offered, where that program is in its lifecycle and whether we enable the same or similar degrees at other universities.

***Period-to-Period Fluctuations***

Our revenue, cash position, accounts receivable and deferred revenue can fluctuate significantly from quarter to quarter due to variations driven by the academic schedules of our clients programs. These programs generally start classes for new and returning students an average of four times per year. Class starts are not necessarily evenly spaced throughout the year, do not necessarily correspond to the traditional academic calendar and may vary from year to year. As a result, the number of classes our client programs have in session, and therefore the number of students enrolled, will vary from month to month and quarter to quarter, leading to variability in our revenue.

Our clients programs often have academic terms that straddle two fiscal quarters. Our clients generally pay us when they have billed tuition and specified fees to their students, which is typically early in the academic term, and once the drop/add period has passed. We recognize the related revenue ratably over the course of the academic term, beginning on the first day of classes through the last. Because we generally receive payments from our clients prior to our ability to recognize the majority of those amounts as revenue, we record deferred revenue at each balance sheet date equal to the excess of the amounts we have billed or received from our clients over the amounts we have recognized as revenue as of that date. For these reasons, our cash flows typically vary considerably from quarter to quarter and our cash position, accounts receivable and deferred revenue typically fluctuate between quarterly balance sheet dates.

Our expense levels also fluctuate from quarter to quarter, driven primarily by our program marketing and sales activity. We typically reduce our paid search and other program marketing and sales efforts during late November and December because these efforts are less productive during the holiday season. This generally results in lower total program marketing and sales expense during the fourth quarter. In addition, because we begin spending on program marketing and sales, and, to a lesser extent, services and support as much as nine months prior to the start of classes for a new client program, these costs as a percentage of revenue fluctuate, sometimes significantly, depending on the timing of new client programs and anticipated program launch dates.

Table of Contents

**Components of Operating Results and Results of Operations**

***Second Quarter 2016 Highlights***

- Revenue was $49.1 million, an increase of 39.4% from $35.2 million in the second quarter of 2015.

- Net loss was $(8.3) million, or $(0.18) per share, compared to $(9.6) million or $(0.23) per share, in the second quarter of 2015.

- Adjusted EBITDA loss was $(2.1) million, compared to an adjusted EBITDA loss of $(4.0) million in the second quarter of 2015.

***Revenue***

Substantially all of our revenue consists of a contractually specified percentage of the amounts our clients bill to their students for tuition and fees, less credit card fees and other specified charges we have agreed to exclude in certain of our client contracts, which we refer to as net program proceeds. Most of our contracts have 10 to 15 year initial terms. We recognize revenue ratably over the service period, which we define as the first through the last day of classes for each academic term in a client s program.

We establish a refund allowance for our share of tuition and fees ultimately uncollected by our clients.

We also offered rebates to a limited group of students who enrolled in a specific client program between 2009 and 2011, which we will be required to pay to such students if they complete their degrees and pre-specified, post-graduation work requirements within a defined period of time after graduation. For students in this group who are still enrolled in the program, we accrue the rebate liability as they continue through the program towards graduation. In addition, all students in this group are required to certify to us each September as to their continuing eligibility for these rebates. For those students who do not make such certification and are therefore no longer eligible for the rebate, because, for example, they have failed to meet their post-graduation work requirements, we reduce the allowance accordingly at that time. As of June 30, 2016 and December 31, 2015, 85 and 81 students, respectively, remained eligible to receive these rebates. These rebates and refunds offset the net program proceeds that we recognize as revenue.

In addition to providing access to the SaaS technology within our Platform, we provide technology-enabled services that support the complete lifecycle of a higher education program, including attracting students, advising prospective students through the admissions application process, providing technical, success coaching and other support, facilitating accessibility to individuals with disabilities and facilitating in-program field placements. We have determined that no individual deliverable has standalone value upon delivery and, therefore, the multiple deliverables within our arrangements do not qualify for treatment as separate units of accounting. Accordingly, we consider all deliverables to be a single unit of accounting, and we recognize revenue from the entire arrangement over the term of the service period.

We generally receive payments from our clients early in each academic term, prior to completion of the service period. We record these advance payments as deferred revenue until the services are delivered or until our obligations are otherwise met, at which time we recognize the revenue. As of each balance sheet date, deferred revenue is a current liability and represents the excess amounts we have billed or received over the amounts we have recognized as revenue in the consolidated statements of operations as of that date.

The components of revenue for the three months ended June 30, 2016 and 2015 were as follows:

| | Three Months Ended June 30, | | | | | |
|---|---|---|---|---|---|---|
| | 2016 | | 2015 | | Period-to-Period Change | |
| | Amount | Percentage of Revenue | Amount | Percentage of Revenue | Amount | Percentage |
| | | | (dollars in thousands) | | | |
| Revenue: | | | | | | |
| Net program proceeds | $ 50,106 | 102.0% | $ 35,662 | 101.2% | $ 14,444 | 40.5% |
| Rebates | | | (1) | (0.0) | 1 | * |
| Refunds | (660) | (1.3) | (262) | (0.7) | (398) | 152.5 |
| Other | (336) | (0.7) | (161) | (0.5) | (175) | 108.8 |
| Total revenue | $ 49,110 | 100.0% | $ 35,238 | 100.0% | $ 13,872 | 39.4 |

* Not meaningful for comparison purposes.

Table of Contents

*Revenue*. Revenue for the three months ended June 30, 2016 was $49.1 million, an increase of $13.9 million, or 39.4%, from $35.2 million for the same period of 2015. The increase was primarily attributable to a 38.8% increase in period-over-period full course equivalent enrollments in our client programs, from 13,557 for the three months ended June 30, 2015 to 18,823 for the three months ended June 30, 2016. Of the increase in full course equivalent enrollments, 635, or 12.1%, were attributable to client programs launched during the 12 months ended June 30, 2016.

The components of revenue for the six months ended June 30, 2016 and 2015 were as follows:

| | Six Months Ended June 30, | | | | Period-to-Period Change | |
|---|---|---|---|---|---|---|
| | 2016 | | 2015 | | | |
| | Amount | Percentage of Revenue | Amount | Percentage of Revenue | Amount | Percentage |
| | (dollars in thousands) | | | | | |
| Revenue: | | | | | | |
| Net program proceeds | $ 98,080 | 101.6% | $ 70,725 | 101.2% | $ 27,355 | 38.7% |
| Rebates | (15) | (0.0) | (3) | (0.0) | (12) | * |
| Refunds | (862) | (0.9) | (646) | (0.9) | (216) | 33.5 |
| Other | (649) | (0.7) | (226) | (0.3) | (423) | 187.4 |
| Total revenue | $ 96,554 | 100.0% | $ 69,850 | 100.0% | $ 26,704 | 38.2 |

* Not meaningful for comparison purposes.

*Revenue*. Revenue for the six months ended June 30, 2016 was $96.5 million, an increase of $26.6 million, or 38.2%, from $69.9 million for the same period of 2015. The increase was primarily attributable to a 37.1% increase in period-over-period full course equivalent enrollments in our client programs, from 26,649 for the six months ended June 30, 2015 to 36,532 for the six months ended June 30, 2016. Of the increase in full course equivalent enrollments, 1,045, or 10.6%, were attributable to client programs launched during the 12 months ended June 30, 2016.

***Costs and Expenses***

Costs and expenses consist of servicing and support costs, technology and content development costs, program marketing and sales expenses and general and administrative expenses. To support our anticipated growth, we expect to continue to hire new employees (which will increase both our cash and non-cash stock-based compensation costs), increase our program promotion and student acquisition efforts, expand our technology infrastructure and increase our other program support capabilities. As a result, we expect our costs and expenses to increase in absolute dollars, but to decrease as a percentage of revenue over time as we achieve economies of scale through the expansion of our business.

*Servicing and support.* Servicing and support expense consists primarily of cash and non-cash stock-based compensation costs related to program management and operations, as well as costs for technical support for our SaaS technology and faculty and student support. It includes costs to facilitate in-program field placements, student immersions and other student enrichment experiences and costs to assist our clients with their state compliance requirements. It also includes software licensing, telecommunications and other costs to provide access to the SaaS technology within our Platform for our clients and their students.

*Technology and content development.* Technology and content development expense consists primarily of cash and non-cash stock-based compensation and outsourced services costs related to the ongoing improvement and maintenance of the SaaS technology within our Platform and the developed content for our client programs. It also includes the costs to support our internal infrastructure, including our cloud-based server usage. Additionally, it includes the associated amortization expense related to capitalized technology and content development costs, as well as hosting and other costs associated with maintaining the SaaS technology within our Platform in a cloud environment.

*Program marketing and sales.* Program marketing and sales expense consists primarily of costs related to student acquisition. This includes the cost of online advertising and prospective student generation, as well as cash and non-cash stock-based compensation costs for our program marketing, search engine optimization, marketing analytics and admissions application counseling personnel. We expense all costs related to program marketing and sales as they are incurred.

*General and administrative.* General and administrative expense consists primarily of cash and non-cash stock-based compensation costs for employees in our executive, administrative, finance and accounting, legal, communications and human resources functions. Additional expenses include external legal, accounting and other professional fees, telecommunications charges and other corporate costs such as insurance and travel that are not related to another function.

Table of Contents

The costs and expenses for the three months ended June 30, 2016 and 2015 were as follows:

| | Three Months Ended June 30, 2016 | | 2015 | | Period-to-Period Change | |
|---|---|---|---|---|---|---|
| | Amount | Percentage of Revenue | Amount | Percentage of Revenue | Amount | Percentage |
| | | | (dollars in thousands) | | | |
| Costs and expenses: | | | | | | |
| Servicing and support | $ 10,260 | 20.9% | $ 7,903 | 22.4% | $ 2,357 | 29.8% |
| Technology and content development | 8,842 | 18.0 | 6,466 | 18.4 | 2,376 | 36.7 |
| Program marketing and sales | 27,483 | 55.9 | 21,526 | 61.0 | 5,957 | 27.7 |
| General and administrative | 10,944 | 22.3 | 8,871 | 25.2 | 2,073 | 23.4 |
| Total costs and expenses | $ 57,529 | 117.1% | $ 44,766 | 127.0% | $ 12,763 | 28.5 |
| Loss from operations | $ (8,419) | (17.1)% | $ (9,528) | (27.0)% | $ 1,109 | (11.6) |

*Servicing and support.* Servicing and support costs for the three months ended June 30, 2016 were $10.3 million, an increase of $2.4 million, or 29.8%, from $7.9 million for the same period of 2015. This increase was due primarily to a $1.4 million increase in cash compensation costs, a $0.3 million increase in non-cash stock-based compensation costs and a $0.3 million increase in travel and related expenses as we increased our headcount in this area by 23% to serve a growing number of students and faculty in existing and new client programs. Additionally, other servicing and support costs increased $0.4 million. As a percentage of revenue, servicing and support costs decreased from 22.4% for the three months ended June 30, 2015 to 20.9% for the same period of 2016, as revenue grew at a higher rate than the increase in expense.

*Technology and content development.* Technology and content development costs for the three months ended June 30, 2016 were $8.8 million, an increase of $2.4 million, or 36.7%, from $6.4 million for the same period of 2015. This increase was due primarily to a $0.5 million increase in cash compensation costs (net of amounts capitalized for technology and content development), a $0.2 million increase in non-cash stock-based compensation costs, a $0.3 million increase in employee technology equipment expenditures and a $0.2 million increase in travel and related expenses as we increased our headcount in this area by 27% to support scaling of existing client programs. Further, an increase of $0.5 million was attributable to upgrades to our Platform and an increase of $0.5 million resulted from higher amortization expense associated with our capitalized technology and content development costs, primarily as a result of an increase in the number of courses that have been developed for our client programs, while other technology and content development expense increased by $0.2 million. As a percentage of revenue, technology and content development costs decreased from 18.4% for the three months ended June 30, 2015 to 18.0% for the same period of 2016, as revenue grew at a higher rate than the increase in expense.

*Program marketing and sales.* Program marketing and sales expense for the three months ended June 30, 2016 was

$27.5 million, an increase of $6.0 million, or 27.7%, from $21.5 million for the same period of 2015. This increase was due primarily to a $2.1 million increase in cash compensation costs, a $0.1 million increase in non-cash stock-based compensation costs and a $0.5 million increase in travel and related expenses as we increased our headcount in this area by 19% to acquire students for, and drive revenue growth in, new client programs. Additionally, direct internet marketing costs to acquire students for our clients programs increased by $2.6 million, and other program marketing and sales expenses increased by $0.7 million to support our program marketing efforts. As a percentage of revenue, program marketing and sales expense decreased from 61.0% for the three months ended June 30, 2015 to 55.9% for the same period of 2016, reflecting a higher year-over-year percentage increase in revenue than the increase in expense.

*General and administrative.* General and administrative expense for the three months ended June 30, 2016 was $10.9 million, an increase of $2.0 million, or 23.4%, from $8.9 million for the same period of 2015. This was due primarily to a $1.3 million increase in cash compensation costs and a $0.3 million increase in non-cash stock-based compensation costs as we increased in our headcount in this area by 28% to support our growing business. Further, employee education benefits increased by $0.7 million, costs associated with the implementation of our enterprise resource planning system integration increased $0.5 million, while other general and administrative costs increased by $0.2 million. These increases were partially offset by a $1.0 million signing bonus of a key executive in June 2015, which consisted of cash and a common stock award signing bonus. As a percentage of revenue, general and administrative expense decreased from 25.2% for the three months ended June 30, 2015 to 22.3% for the same period of 2016, reflecting a higher year-over-year percentage increase in revenue than the increase in expense.

Non-cash stock-based compensation expense is a component of compensation cost within each of the four cost and expense categories described above. In early 2014, the Compensation Committee of our Board of Directors approved a framework for granting equity awards under our 2014 Equity Incentive Plan. Under this framework, the majority of our equity awards are made on or around April 1

Table of Contents

of each year and typically have four-year vesting periods. As such, non-cash stock-based compensation expense is expected to continue to increase year-over-year until four years after the initial mid-2014 grants.

The costs and expenses for the six months ended June 30, 2016 and 2015 were as follows:

| | Six Months Ended June 30, | | | | | |
|---|---|---|---|---|---|---|
| | 2016 | | 2015 | | Period-to-Period Change | |
| | Amount | Percentage of Revenue | Amount | Percentage of Revenue | Amount | Percentage |
| | | | (dollars in thousands) | | | |
| Costs and expenses: | | | | | | |
| Servicing and support | $ 19,772 | 20.5% | $ 15,454 | 22.1% | $ 4,318 | 27.9% |
| Technology and content development | 16,117 | 16.7 | 12,600 | 18.0 | 3,517 | 27.9 |
| Program marketing and sales | 51,139 | 52.9 | 41,113 | 58.9 | 10,026 | 24.4 |
| General and administrative | 21,391 | 22.2 | 15,582 | 22.3 | 5,809 | 37.3 |
| Total costs and expenses | $ 108,419 | 112.3% | $ 84,749 | 121.3% | $ 23,670 | 27.9 |
| Loss from operations | $ (11,865) | (12.3)% | $ (14,899) | (21.3)% | $ 3,034 | (20.4) |

*Servicing and support.* Servicing and support costs for the six months ended June 30, 2016 were $19.8 million, an increase of $4.4 million, or 27.9%, from $15.4 million for the same period of 2015. This increase was due primarily to a $2.6 million increase in cash compensation costs, a $0.6 million increase in non-cash stock-based compensation costs and a $0.6 million increase in travel and related expenses as we increased our headcount in this area by 32% to serve a growing number of students and faculty in existing and new client programs. Additionally, other servicing and support costs increased $0.6 million. As a percentage of revenue, servicing and support costs decreased from 22.1% for the six months ended June 30, 2015 to 20.5% for the same period of 2016, as revenue grew at a higher rate than the increase in expense.

*Technology and content development.* Technology and content development costs for the six months ended June 30, 2016 were $16.1 million, an increase of $3.5 million, or 27.9%, from $12.6 million for the same period of 2015. This increase was due primarily to a $1.1 million increase in cash compensation costs (net of amounts capitalized for technology and content development), a $0.4 million increase in non-cash stock-based compensation costs, a $0.4 million increase in employee technology equipment expenditures and a $0.3 million increase in travel and related expenses, as we increased our headcount in this area by 34% to support scaling of existing client programs. Further, an increase of $0.8 million resulted from higher amortization expense associated with our capitalized technology and content development costs, primarily as a result of an increase in the number of courses that have been developed for our client programs. Additionally, costs related to our cloud-based server usage increased by $0.1 million, while other technology and content development expense increased by $0.4 million. As a percentage of revenue, technology and content development costs decreased from 18.0% for the six months ended June 30, 2015 to 16.7% for the same period of 2016, as revenue grew at a higher rate than the increase in expense.

*Program marketing and sales.* Program marketing and sales expense for the six months ended June 30, 2016 was $51.1 million, an increase of $10.0 million, or 24.4%, from $41.1 million for the same period of 2015. This increase was due primarily to a $3.9 million increase in cash compensation costs, a $0.2 million increase in non-cash stock-based compensation costs and a $0.5 million increase in travel and related expenses as we increased our headcount in this area by 21% to acquire students for, and drive revenue growth in, new client programs. Additionally, direct internet marketing costs to acquire students for our clients programs increased by $4.2 million, and other program marketing and sales expenses increased by $1.2 million to support our program marketing efforts. As a percentage of revenue, program marketing and sales expense decreased from 58.9% for the six months ended June 30, 2015 to 52.9% for the same period of 2016, reflecting a higher year-over-year percentage increase in revenue than the increase in expense.

*General and administrative.* General and administrative expense for the six months ended June 30, 2016 was $21.4 million, an increase of $5.8 million, or 37.3%, from $15.6 million for the same period of 2015. This was due primarily to a $2.3 million increase in cash compensation costs and a $1.2 million increase in non-cash stock-based compensation costs as we increased in our headcount in this area by 35% to support our growing business. Further, employee education benefits increased by $1.2 million, costs associated with the implementation of our enterprise resource planning system integration increased $1.0 million, accounting services primarily related to Sarbanes-Oxley compliance and other professional fees increased by $0.4 million, while other general and administrative costs increased by $0.7 million. These increases were partially offset by a $1.0 million signing bonus of a key executive in June 2015, which consisted of cash and a common stock award signing bonus. As a percentage of revenue, general and administrative expense decreased from 22.3% for the three months ended June 30, 2015 to 22.2% for the same period of 2016, reflecting a higher year-over-year percentage increase in revenue than the increase in expense.

Table of Contents

*Other Income (Expense)*

Other income (expense) consists of interest income, interest expense and other expenses. Interest income is derived from interest received on our cash and cash equivalents. Interest expense consists primarily of the amortization of deferred financing costs associated with our line of credit.

*Income Tax (Expense) Benefit*

Income tax expense consists of U.S. federal, state and foreign income taxes. To date, we have not been required to pay U.S. federal income taxes because of our current and accumulated net operating losses. We incurred immaterial state and foreign income tax liabilities for the three and six months ended June 30, 2016 and 2015.

**Key Business and Financial Performance Metrics**

We use a number of key metrics to evaluate our business, measure our performance, identify trends affecting our business, formulate financial projections and make strategic decisions. In addition to adjusted EBITDA, which we discuss below, we discuss revenue and the components of operating loss in the section above entitled Components of Operating Results and Results of Operations. Additionally, we utilize other key metrics to evaluate the success of our growth strategy, including measures we refer to as Platform revenue retention rate and full course equivalent enrollments in our clients programs.

*Platform Revenue Retention Rate*

We measure our Platform revenue retention rate for a particular period by first identifying the group of programs that our clients launched before the beginning of the prior year comparative period. We then calculate our Platform revenue retention rate by comparing the revenue we recognized for this group of programs in the reporting period to the revenue we recognized for the same group of programs in the prior year comparative period, expressed as a percentage of the revenue we recognized for the group in the prior year comparative period.

The following table sets forth our Platform revenue retention rate for the periods presented, as well as the number of programs included in the Platform revenue retention rate calculation. For all of these periods, our Platform revenue retention rate was greater than 100% because we had no programs terminate and full course equivalent enrollments in the aggregate increased year-over-year. There is no direct correlation between the Platform revenue retention rate and the number of programs included in the calculation of that rate. However, there may be a correlation between the Platform revenue retention rate and the average maturity of the programs included in the calculation of that rate because newer programs tend to have higher percentage growth rates.

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2016 | 2015 | 2016 | 2015 |
| Platform revenue retention rate | 134.2% | 130.5% | 123.7% | 124.8% |
| Number of programs included in comparison (1) | 15 | 10 | 12 | 9 |

(1) Reflects the number of programs operating both in the reported period and in the prior year comparative period.

***Full Course Equivalent Enrollments in Our Clients Programs***

We measure full course equivalent enrollments in our clients programs by determining, for each of the courses offered during a particular period, the number of students enrolled in that course multiplied by the percentage of the course completed during that period. We use this metric to account for the fact that many courses offered by our clients straddle two or more fiscal quarters. For example, if a course had 25 enrolled students and 40% of the course was completed during a particular period, we would count the course as having 10 full course equivalent enrollments for that period. Any individual student may be enrolled in more than one course during a period.

Average revenue per full course equivalent enrollment represents our weighted-average revenue per course across the mix of courses being offered in our client programs during a period. This number is derived by dividing our total revenue for a period by the number of full course equivalent enrollments during that same period. This amount may vary from period to period depending on the academic calendars of our clients, the relative growth rates of programs with varying tuition levels, the launch of new programs with higher or lower than average net tuition costs and annual tuition increases instituted by our clients. As a part of our growth strategy, we are actively targeting new graduate-level clients in academic disciplines for which we have existing programs. Over time, this strategy is

Table of Contents

likely to reduce our average revenue per full course equivalent. However, we believe this approach will enable us to leverage our program marketing investments across multiple client programs within specific academic disciplines, significantly decreasing student acquisition costs within those disciplines and more than offsetting any decline in average revenue per full course equivalent enrollment.

The following table sets forth the full course equivalent enrollments and average revenue per full course equivalent enrollment in our clients programs for the periods presented.

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2016 | 2015 | 2016 | 2015 |
| Full course equivalent enrollments in our clients programs | 18,823 | 13,557 | 36,532 | 26,649 |
| Average revenue per full course equivalent enrollment in our clients programs | $ 2,609 | $ 2,599 | $ 2,643 | $ 2,621 |

***Adjusted EBITDA***

Adjusted EBITDA represents our earnings before net interest (income) expense, income taxes, depreciation and amortization, adjusted to eliminate stock-based compensation expense, which is a non-cash item. Adjusted EBITDA is a key measure used by our management and board of directors to understand and evaluate our core operating performance and trends, to prepare and approve our annual budget and to develop short- and long-term operational plans. In particular, the exclusion of certain expenses in calculating adjusted EBITDA can provide a useful measure for period-to-period comparisons of our core business. Accordingly, we believe that adjusted EBITDA provides useful information to investors and others in understanding and evaluating our operating results in the same manner as our management and board of directors.

Adjusted EBITDA is not a measure calculated in accordance with U.S. GAAP, and should not be considered as an alternative to any measure of financial performance calculated and presented in accordance with U.S. GAAP. In addition, adjusted EBITDA may not be comparable to similarly titled measures of other companies because other companies may not calculate adjusted EBITDA in the same manner as we do. We prepare adjusted EBITDA to eliminate the impact of stock-based compensation expense, which we do not consider indicative of our core operating performance.

Our use of adjusted EBITDA has limitations as an analytical tool, and you should not consider it in isolation or as a substitute for analysis of our financial results as reported under U.S. GAAP. Some of these limitations are:

- although depreciation and amortization are non-cash charges, the assets being depreciated and amortized may have to be replaced in the future, and adjusted EBITDA does not reflect cash capital expenditure requirements for such replacements or for new capital expenditure requirements;

- adjusted EBITDA does not reflect changes in, or cash requirements for, our working capital needs;

- adjusted EBITDA does not reflect the potentially dilutive impact of equity-based compensation;

- adjusted EBITDA does not reflect interest or tax payments that may represent a reduction in cash available to us; and

- other companies, including companies in our industry, may calculate adjusted EBITDA differently, which reduces its usefulness as a comparative measure.

Because of these and other limitations, you should consider adjusted EBITDA alongside other U.S. GAAP-based financial performance measures, including various cash flow metrics, net income (loss) and our other U.S. GAAP results. The following table presents a reconciliation of net loss to adjusted EBITDA for each of the periods indicated.

Table of Contents

| | Three Months Ended June 30, 2016 | Three Months Ended June 30, 2015 | Six Months Ended June 30, 2016 | Six Months Ended June 30, 2015 |
|---|---|---|---|---|
| | (in thousands) | | | |
| Net loss | $ (8,337) | $ (9,630) | $ (11,717) | $ (15,098) |
| Adjustments: | | | | |
| Interest expense | 9 | 126 | 35 | 252 |
| Interest income | (91) | (24) | (183) | (53) |
| Depreciation and amortization expense | 2,377 | 1,677 | 4,526 | 3,390 |
| Stock-based compensation expense | 3,976 | 3,867 | 7,520 | 5,915 |
| Total adjustments | 6,271 | 5,646 | 11,898 | 9,504 |
| Adjusted EBITDA (loss) | $ (2,066) | $ (3,984) | $ 181 | $ (5,594) |

**Liquidity and Capital Resources**

***Sources of Liquidity***

On December 31, 2013, we entered into a credit agreement with Comerica Bank for a revolving line of credit, under which we could borrow up to $37.0 million from a syndicate of lenders including Comerica Bank and Square 1 Bank, with a maturity date of December 31, 2015. On December 31, 2015, we amended this credit agreement to reduce the aggregate amount we may borrow to $25.0 million and on July 26, 2016, we amended this credit agreement to extend the maturity date through October 1, 2016. No amounts were outstanding as of June 30, 2016 or December 31, 2015.

In connection with entering into an operating lease agreement on December 23, 2015, to lease our new office facility in Lanham, Maryland, we entered into a standby letter of credit on January 22, 2016 in the amount of $6.0 million as a security deposit for the new leased facilities. In connection with entering into an operating lease agreement on May 11, 2016, to lease new office space in Denver, Colorado, we entered into a standby letter of credit on June 14, 2016 in the amount of $1.1 million as a security deposit for the new leased facilities. These letters of credit reduced the aggregate amount we may borrow under our revolving line of credit to $17.9 million.

Under this revolving line of credit, we have the option of borrowing funds subject to (i) a base rate, which is equal to 1.5% plus the greater of Comerica Bank s prime rate, the federal funds rate plus 1% or the 30 day LIBOR plus 1%, or (ii) LIBOR plus 2.5%. For amounts borrowed under the base rate, we may make interest-only payments quarterly, and may prepay such amounts with no penalty. For amounts borrowed under LIBOR, we may make interest-only payments in periods of one, two and three months and will be subject to a prepayment penalty if we repay such borrowed amounts before the end of the interest period.

Borrowings under the line of credit are collateralized by substantially all of our assets. The availability of borrowings under this credit line is subject to our compliance with reporting and financial covenants, including, among other things, that we achieve specified minimum three-month trailing revenue levels during the term of the agreement and specified minimum six-month trailing profitability levels for some of our client programs, measured quarterly. In addition, we are required to maintain a minimum adjusted quick ratio, which measures our short-term liquidity, of at least 1.10 to 1.00. As of June 30, 2016 and December 31, 2015, our adjusted quick ratios were 7.95 and 7.90, respectively.

The covenants under the line of credit also place limitations on our ability to incur additional indebtedness or to prepay permitted indebtedness, grant liens on or security interests in our assets, carry out mergers and acquisitions, dispose of assets, declare, make or pay dividends, make capital expenditures in excess of specified amounts, make investments, loans or advances, enter into transactions with our affiliates, amend or modify the terms of our material contracts, or change our fiscal year. If we are not in compliance with the covenants under the line of credit, after any opportunity to cure such non-compliance, or we otherwise experience an event of default under the line of credit, the lenders may require repayment in full of all principal and interest outstanding. If we fail to repay such amounts, the lenders could foreclose on the assets we have pledged as collateral under the line of credit. We are currently in compliance with all such covenants.

Table of Contents

***Cash Flows***

The following table summarizes our cash flows for the periods presented.

| | Six Months Ended June 30, 2016 | | Six Months Ended June 30, 2015 | |
|---|---|---|---|---|
| | (in thousands) | | | |
| Cash provided by (used in): | | | | |
| Operating activities | $ | 11,507 | $ | 6,042 |
| Investing activities | | (8,608) | | (6,538) |
| Financing activities | | 1,623 | | 1,791 |

*Operating Activities*

For the six months ended June 30, 2016, net cash provided by operating activities of $11.5 million consisted of $12.0 million in non-cash items and an $11.2 million net cash inflow from changes in working capital, partially offset by a net loss of $11.7 million. Non-cash items consisted of non-cash stock-based compensation charges of $7.5 million and depreciation and amortization expense of $4.5 million. The increase in cash resulting from changes in working capital consisted of a $15.0 million increase in deferred revenue and a $4.8 million increase in accrued expenses and other liabilities. These increases were partially offset by a $4.3 million increase in accounts receivable, a $3.4 million decrease in accrued compensation and related benefits and other changes in working capital of $0.9 million.

For the six months ended June 30, 2015, net cash provided by operating activities was $6.0 million, consisting of an $11.8 million net cash inflow from changes in working capital and $9.3 million in non-cash items, partially offset by a net loss of $15.1 million. The increase in cash resulting from changes in working capital consisted of increases in deferred revenue of $11.5 million and accrued expenses and other current liabilities of $8.1 million due to higher accrued program marketing costs. These increases in cash were partially offset by increases in accounts receivable of $4.0 million, a $1.5 million decrease in accrued compensation and related benefits, a $1.4 million increase in other assets and other liabilities and other changes in working capital of $0.9 million. Non-cash items consisted of non-cash stock compensation charges of $5.9 million and depreciation and amortization expense of $3.4 million.

*Investing Activities*

For the six months ended June 30, 2016 and 2015, net cash used in investing activities was $8.6 million and $6.5 million, respectively. These expenditures were primarily for the development of internal-use software and asynchronous content developed for client programs, and equipment.

*Financing Activities*

For the six months ended June 30, 2016, net cash provided by financing activities was $1.6 million, consisting of $2.1 million of proceeds received from the exercise of stock options, partially offset by $0.5 million of cash used for the payment of employee withholding taxes related to the release of restricted stock units.

For the six months ended June 30, 2015, net cash provided by financing activities was $1.8 million, consisting of $2.2 million of proceeds received from the exercise of stock options, partially offset by $0.4 million of cash used for the payment of employee withholding taxes related to the release of restricted stock units.

**Contractual Obligations and Commitments**

We have non-cancelable operating leases for our office space, and we are also contractually obligated to make fixed payments to certain of our university clients in exchange for contract extensions and various marketing and other rights.

We have a $25.0 million line of credit from Comerica Bank and no amounts were outstanding as of June 30, 2016.

See Note 5 in the Notes to Condensed Consolidated Financial Statements included in Part I, Item 1 and Legal Proceedings contained in Part II, Item 1 of this Quarterly Report on Form 10-Q for additional information regarding contingencies.

Table of Contents

**Recent Accounting Pronouncements**

Refer to Note 2 in the Notes to Condensed Consolidated Financial Statements included in Part I, Item 1 of this Quarterly Report on Form 10-Q for a discussion of FASB s recent accounting pronouncements and their effect on us.

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

Market risk is the risk of loss to future earnings, values or future cash flows that may result from changes in the price of a financial instrument. The value of a financial instrument may change as a result of changes in interest rates, exchange rates, commodity prices, equity prices and other market changes. Our exposure to market risk related to changes in foreign currency exchange rates is deemed

low as further described below. In addition, we do not use derivative financial instruments for speculative, hedging or trading purposes, although in the future we may enter into exchange rate hedging arrangements to manage the risks described in the succeeding paragraphs.

***Interest Rate Risk***

We are subject to interest rate risk in connection with potential borrowings available under our bank line of credit which was procured in December 2013, as amended. Borrowings under the revolving line of credit bear interest at variable rates. Increases in LIBOR or our lender s prime rate would increase the amount of interest payable on any borrowings outstanding under this line of credit. No amounts were outstanding under this line of credit as of June 30, 2016.

***Foreign Currency Exchange Risk***

All of our current client contracts are denominated in U.S. dollars. Therefore, we have minimal, if any, foreign currency exchange risk with respect to our revenue.

We have a branch office in Hong Kong for program marketing and student support and incur expenses related to its operations. The functional currency of this office is Hong Kong dollars, which exposes us to changes in foreign currency exchange rates. Hong Kong dollar currency rates have historically been tied to the U.S. dollar, however. In addition, because of the small size of our Hong Kong office and the relatively nominal amount of our expenses denominated in Hong Kong dollars, we do not expect any material effect on our financial position or results of operations from fluctuations in exchange rates. However, our exposure to foreign currency exchange risk may change over time as business practices evolve, and if our exposure increases, adverse movement in foreign currency exchange rates could have a material adverse impact on our financial results.

### *Inflation*

We do not believe that inflation has had a material effect on our business, financial condition or results of operations. Through our pricing model, we benefit from price increases implemented by our clients, and we continue to monitor inflation-driven cost increases in order to minimize their effects through productivity improvements and cost containment efforts. If our costs were to become subject to significant inflationary pressures, the price increases implemented by our clients and our own pricing strategies might not fully offset the higher costs. Our inability or failure to do so could harm our business, financial condition and results of operations.

## Item 4. Controls and Procedures

### *Evaluation of Disclosure Controls and Procedures*

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our reports under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC s rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure based on the definition of disclosure controls and procedures as promulgated under the Exchange Act and the rules and regulations thereunder. In designing and

Table of Contents

evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on this evaluation, management concluded that our disclosure controls and procedures were effective as of June 30, 2016.

***Changes in Internal Control Over Financial Reporting***

There have been no changes in our internal control over financial reporting that occurred during the quarter ended June 30, 2016 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**PART II. OTHER INFORMATION**

## Item 1. Legal Proceedings

The information required by this Item is incorporated herein by reference to Note 5 in Notes to Condensed Consolidated Financial Statements included in Part I, Item 1 of this Quarterly Report on Form 10-Q.

## Item 1A. Risk Factors

The risks described in Part I, Item 1A Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2015, which was filed with the SEC on March 10, 2016, remain current in all material respects. Those risk factors do not identify all risks that we face. Our operations could also be affected by factors that are not presently known to us or that we currently consider to be immaterial to our operations.

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

None.

## Item 3. Defaults Upon Senior Securities

None.

## Item 4. Mine Safety Disclosures

None.

## Item 5. Other Information

None.

## Item 6. Exhibits

| **Exhibit Number** | **Description of the Document** |
|---|---|
| 3.1 (1) | Amended and Restated Certificate of Incorporation of the Registrant. |
| 3.2 (2) | Amended and Restated Bylaws of the Registrant. |
| 31.1 | Certification of Chief Executive Officer of 2U, Inc. pursuant to Exchange Act Rule 13a-14(a)/15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 31.2 | Certification of Chief Financial Officer of 2U, Inc. pursuant to Exchange Act Rule 13a-14(a)/15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 32.1 | Certification of Chief Executive Officer of 2U, Inc. in accordance with 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 32.2 | Certification of Chief Financial Officer of 2U, Inc. in accordance with 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 101.INS | XBRL Instance |
| 101.SCH | XBRL Taxonomy Extension Schema Document |
| 101.CAL | XBRL Taxonomy Extension Calculation Linkbase Document |
| 101.DEF | XBRL Taxonomy Extension Definition Linkbase Document |
| 101.LAB | XBRL Taxonomy Extension Labels Linkbase Document |

Table of Contents

| | |
|---|---|
| 101.PRE | XBRL Taxonomy Extension Presentation Linkbase Document |

(1) Previously filed as Exhibit 3.1 to the Registrant s Current Report on Form 8-K (File No. 001-36376), filed with the Commission on April 4, 2014, and incorporated by reference herein.

(2) Previously filed as Exhibit 3.2 to the Registrant s Current Report on Form 8-K (File No. 001-36376), filed with the Commission on April 4, 2014, and incorporated by reference herein.

Table of Contents

**SIGNATURES**

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

| | | |
|---|---|---|
| | **2U, Inc.** | |
| August 4, 2016 | By: | /s/ Christopher J. Paucek<br>Christopher J. Paucek<br>Chief Executive Officer |
| August 4, 2016 | By: | /s/ Catherine A. Graham<br>Catherine A. Graham<br>Chief Financial Officer |