

2U, Inc.  
Form 10-Q  
August 07, 2017  
[Table of Contents](#)

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

(Mark One)

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

For the quarterly period ended June 30, 2017

or

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

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

Commission File Number: 001-36376

## 2U, INC.

(Exact name of registrant as specified in its charter)

**Delaware**

(State or other jurisdiction of incorporation or organization)

**26-2335939**

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

**7900 Harkins Road,  
Lanham, MD**

(Address of principal executive offices)

**20706**

(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.  Yes  No

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

Emerging growth company

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

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

Edgar Filing: 2U, Inc. - Form 10-Q

As of August 1, 2017, there were 47,924,767 shares of the registrant's common stock, par value \$0.001 per share, outstanding.

---



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, 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;
- our ability to successfully integrate the operations of Get Educated International Proprietary Limited, or GetSmarter, achieve the expected benefits of the acquisition and manage, expand and grow the combined company;
- our ability to execute our growth strategy in the international, undergraduate and non-degree alternative 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 this Quarterly Report on Form 10-Q and in our Annual Report on Form 10-K for the year ended December 31, 2016 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)**

	<b>June 30, 2017</b>	<b>December 31, 2016</b>
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 37,435	\$ 168,730
Restricted cash	100,987	
Accounts receivable, net	23,426	7,860
Advances to clients	213	567
Prepaid expenses and other assets	8,398	7,541
Total current assets	170,459	184,698
Property and equipment, net	34,390	15,596
Capitalized technology and content development costs, net	37,402	31,867
Advances to clients, non-current	2,163	2,100
Prepaid expenses, non-current	14,789	7,052
Other non-current assets	2,770	3,007
Total assets	\$ 261,973	\$ 244,320
<b>Liabilities and stockholders' equity</b>		
Current liabilities:		
Accounts payable	\$ 4,323	\$ 3,729
Accrued compensation and related benefits	17,908	16,491
Accrued expenses and other liabilities	22,324	17,712
Deferred revenue	7,365	3,137
Total current liabilities	51,920	41,069
Non-current lease-related liabilities	15,202	7,620
Deferred government grant obligations	3,500	
Other non-current liabilities	300	394
Total liabilities	70,922	49,083
Commitments and contingencies (Note 4)		
Stockholders' equity:		
Preferred stock, \$0.001 par value, 5,000,000 shares authorized, 0 shares issued and outstanding as of June 30, 2017 and December 31, 2016		
Common stock, \$0.001 par value, 200,000,000 shares authorized, 47,858,326 shares issued and outstanding as of June 30, 2017; 47,151,635 shares issued and outstanding as of December 31, 2016		
	48	47
Additional paid-in capital	382,609	371,455
Accumulated deficit	(191,606)	(176,265)
Total stockholders' equity	191,051	195,237
Total liabilities and stockholders' equity	\$ 261,973	\$ 244,320

Edgar Filing: 2U, Inc. - Form 10-Q

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,		Six Months Ended June 30,	
	2017	2016	2017	2016
Revenue	\$ 64,995	\$ 49,110	\$ 129,824	\$ 96,554
Costs and expenses:				
Servicing and support	13,458	10,260	24,383	19,772
Technology and content development	11,140	8,842	20,345	16,117
Program marketing and sales	37,242	27,483	71,912	51,139
General and administrative	13,930	10,944	27,594	21,391
Total costs and expenses	75,770	57,529	144,234	108,419
Loss from operations	(10,775)	(8,419)	(14,410)	(11,865)
Other income (expense):				
Interest income	53	91	249	183
Interest expense	(1)	(9)	(1)	(35)
Foreign currency loss	(1,031)		(1,031)	
Total other income (expense)	(979)	82	(783)	148
Loss before income taxes	(11,754)	(8,337)	(15,193)	(11,717)
Income tax expense				
Net loss	\$ (11,754)	\$ (8,337)	\$ (15,193)	\$ (11,717)
Net loss per share, basic and diluted	\$ (0.25)	\$ (0.18)	\$ (0.32)	\$ (0.25)
Weighted-average shares of common stock outstanding, basic and diluted	47,668,397	46,494,464	47,454,059	46,226,117

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			Additional	Accumulated	Total
	Shares	Amount		Paid-In	Deficit	Stockholders
				Capital		Equity
Balance, December 31, 2016	47,151,635	\$ 47	\$	371,455	\$ (176,265)	\$ 195,237
Cumulative-effect of accounting change (Note 2)				148	(148)	
Balance, December 31, 2016, adjusted	47,151,635	47		371,603	(176,413)	195,237
Exercise of stock options	271,579			2,908		2,908
Issuance of common stock in connection with settlement of restricted stock units, net of withholdings	435,112	1		(1,292)		(1,291)
Stock-based compensation expense				9,390		9,390
Net loss					(15,193)	(15,193)
Balance, June 30, 2017	47,858,326	\$ 48	\$	382,609	\$ (191,606)	\$ 191,051

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,	
	2017	2016
<b>Cash flows from operating activities</b>		
Net loss	\$ (15,193)	\$ (11,717)
Adjustments to reconcile net loss to net cash (used in) provided by operating activities:		
Depreciation and amortization	7,431	4,526
Stock-based compensation expense	9,390	7,520
Foreign currency loss	1,031	
Changes in operating assets and liabilities:		
Increase in accounts receivable, net	(15,566)	(4,267)
Decrease in advances to clients	291	75
Increase in prepaid expenses and other current assets	(112)	(645)
Increase in accounts payable	594	1,044
Increase (decrease) in accrued compensation and related benefits	1,417	(3,419)
Increase in accrued expenses and other liabilities	4,262	4,776
Increase in deferred revenue	4,228	14,978
(Increase) decrease in payments to clients	(7,471)	1,664
Decrease (increase) in other assets and other liabilities, net	1,561	(3,028)
Net cash (used in) provided by operating activities	(8,137)	11,507
<b>Cash flows from investing activities</b>		
Purchases of property and equipment	(15,449)	(1,029)
Capitalized technology and content development cost expenditures	(10,808)	(7,437)
Other		(142)
Net cash used in investing activities	(26,257)	(8,608)
<b>Cash flows from financing activities</b>		
Proceeds from deferred government grant obligations	3,500	
Proceeds from exercise of stock options	2,908	2,156
Tax withholding payments associated with settlement of restricted stock units	(1,291)	(365)
Other		(168)
Net cash provided by financing activities	5,117	1,623
Effect of exchange rate changes on cash	(1,031)	
Net (decrease) increase in cash, cash equivalents and restricted cash	(30,308)	4,522
Cash, cash equivalents and restricted cash, beginning of period	168,730	183,729
Cash, cash equivalents and restricted cash, end of period	\$ 138,422	\$ 188,251

See accompanying notes to condensed consolidated financial statements.

Table of Contents

**2U, Inc.**

**Notes to Condensed Consolidated Financial Statements**

**(unaudited)**

**1. Organization, Basis of Presentation and Recent Accounting Pronouncements**

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 digital 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) a comprehensive suite of integrated applications, which the Company uses to launch, operate and support the Company s clients programs. The Company also provides a suite of technology-enabled services optimized with data analysis and machine learning techniques 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.

***Basis of Presentation***

The accompanying condensed consolidated financial statements have been prepared in accordance with: (i) generally accepted accounting principles in the United States ( U.S. GAAP ) for interim financial information; (ii) the instructions to Form 10-Q; and (iii) the guidance of Rule 10-01 of Regulation S-X under the Securities and Exchange Act of 1934, as amended, for financial statements required to be filed with the Securities and Exchange Commission ( SEC ). They include the assets, liabilities, results of operations and cash flows of the Company, including its wholly owned subsidiaries. As permitted under such rules, certain notes and other financial information normally required by GAAP have been condensed or omitted. The Company believes the accompanying condensed consolidated financial statements reflect all normal and recurring adjustments necessary for a fair statement of the Company s financial position, results of operations, and cash flows as of and for the periods presented herein. The Company s results of operations for the three and six months ended June 30, 2017 and 2016 may not be indicative of the Company s future results. These condensed consolidated financial statements are unaudited and should be read in conjunction with the Company s audited consolidated financial statements and the notes thereto included in the Company s Annual Report on Form 10-K for the fiscal year ended December 31, 2016. All significant intercompany accounts and transactions have been eliminated in consolidation.

The year-end condensed consolidated balance sheet data was derived from the audited financial statements, but does not include all disclosures required by GAAP.

***Reclassifications***

Certain prior period amounts in the condensed consolidated balance sheets and condensed consolidated statements of cash flows have been reclassified to conform to the current period's presentation.

***Use of Estimates***

The preparation of the condensed consolidated financial statements in accordance with U.S. GAAP requires management to make certain estimates and assumptions that affect the amounts reported herein. 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.

***Recent Accounting Pronouncements***

In November 2016, the Financial Accounting Standards Board ( FASB ) issued Accounting Standards Update ( ASU ) No. 2016-18, *Statement of Cash Flows (Topic 230): Restricted Cash*, a consensus of the FASB Emerging Issues Task Force. The ASU requires companies to explain the changes in the combined total of restricted and unrestricted cash balances in the statement of cash flows. The amendments in this ASU are effective for fiscal years beginning after December 15, 2017, with early adoption permitted. Adoption of the ASU is retrospective to each prior period presented. The Company early adopted this ASU in the second quarter of 2017. Adoption of this standard did not have a significant impact on the presentation of prior periods.

In August 2016, the Financial Accounting Standards Board ( FASB ) issued Accounting Standards Update ( ASU ) No. 2016-15, *Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments*. The ASU addresses eight specific cash flow issues with the objective of reducing the existing diversity in practice surrounding how certain transactions are classified in

Table of Contents

the statement of cash flows. The amendments in this ASU are effective for annual reporting periods beginning after December 15, 2017. The Company is currently evaluating the effect that this standard will have on its consolidated statements of cash flows and related disclosures.

In March 2016, the FASB issued ASU No. 2016-09, *Compensation – Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting*. 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, and allows companies to elect an accounting policy to either estimate the share-based award forfeitures (and expense) or account for forfeitures (and expense) as they occur. The amendments in this ASU are effective for fiscal years beginning after December 15, 2016. The Company adopted this ASU on January 1, 2017. In connection with the adoption of this standard, the Company elected to no longer apply an estimated forfeiture rate and will instead account for forfeitures as they occur. Accordingly, the Company applied the modified retrospective adoption approach, which resulted in a \$0.1 million cumulative-effect reduction to retained earnings with an offset to additional paid-in-capital.

In February 2016, the FASB issued ASU No. 2016-02, *Leases (Topic 842)*. 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 ASU will have on its consolidated financial position and related disclosures, and believes that this standard may materially increase its other non-current assets and non-current liabilities on the consolidated balance sheets in order to record right-of-use assets and related liabilities for its existing operating leases.

In August 2014, the FASB issued ASU No. 2014-15, *Presentation of Financial Statements – Going Concern (Subtopic 205-40): 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 adopted this ASU on January 1, 2017. Adoption of this standard did not have a significant impact on the Company's financial reporting process.

In May 2014, the FASB issued ASU No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*, 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. Subsequently, the FASB has issued the following standards related to ASU No. 2014-09: ASU No. 2016-08, *Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations*; ASU No. 2016-10, *Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing*; ASU No. 2016-12, *Revenue from Contracts with Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients*; and ASU No. 2016-20, *Technical Corrections and Improvements to Topic 606, Revenue from Contracts with Customers*. The Company must adopt ASU No. 2016-08, ASU No. 2016-10, ASU No. 2016-12 and ASU No. 2016-20 with ASU No. 2014-09 (collectively, the new revenue standard). The new revenue standard may be applied retrospectively to each prior period presented or retrospectively with the cumulative effect recognized as of the date of adoption. The Company has assembled a multidisciplinary

## Edgar Filing: 2U, Inc. - Form 10-Q

team that includes independent third-party consultants to assist with the implementation of the new revenue standard and has made progress with its assessment of the impact of the new revenue standard during the second quarter of 2017. While the Company has not completed its assessment of the impact of adopting the new revenue standard, the Company is in the process of reviewing the current accounting policies and practices to identify potential differences that could result from applying the requirements of the new revenue standard to its revenue contracts and expects to complete the assessment effort by the end of the third quarter of 2017. Over the second half of 2017, the Company will complete the quantification of any identified impacts, the evaluation and implementation of any necessary changes to its business processes and controls in order to support revenue recognition and disclosure under the new revenue standard, and the determination of which transition approach will be applied. The Company will provide additional updates on progress made and further conclusions in its third quarter report on Form 10-Q to be filed in 2017, and adopt the new revenue standard on January 1, 2018.

Table of Contents

**2. Summary of Significant Accounting Policies**

***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, 2017, four clients each accounted for 10% or more of the Company's revenue, as follows: \$19.1 million, \$12.1 million, \$6.9 million and \$6.8 million, which equals 29%, 19%, 11% and 10% of total revenue, respectively.

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 six months ended June 30, 2017, four clients each accounted for 10% or more of the Company's revenue, as follows: \$38.8 million, \$23.8 million, \$13.8 million and \$13.2 million, which equals 30%, 18%, 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.

As of June 30, 2017, two clients each accounted for 10% or more of the Company's accounts receivable balance, as follows: \$14.1 million and \$5.3 million, which equals 61% and 23% of total accounts receivable, respectively. As of December 31, 2016, two clients each accounted for 10% or more of the Company's accounts receivable balance, as follows: \$5.8 million and \$1.4 million, which equals 74% and 17% of total accounts receivable, respectively.

***Restricted Cash***

Restricted cash includes a 1.2 billion South African rand denominated restricted cash balance at June 30, 2017, which was held in connection with the Company's acquisition of GetSmarter on July 1, 2017, as further discussed in Note 10



below.

### *Non-cash Investing and Financing Activities*

During the six months ended June 30, 2017, the Company had new capital asset additions of \$31.6 million, which was comprised of \$15.6 million of leasehold improvements, \$10.5 million in capitalized technology and content development costs and \$5.5 million of other property and equipment. The \$31.6 million increase consisted of \$26.3 million in cash capital expenditures, with the remainder primarily comprised of landlord funded leasehold improvements.

During the six months ended June 30, 2016, the Company had new capital asset additions of \$9.1 million, which was primarily comprised of capitalized technology and content development costs. The increase consisted almost entirely of cash capital expenditures.

### *Government Grants*

Government grants awarded to the Company in the form of forgivable loans are recorded as deferred government grant obligations within long-term liabilities on the condensed consolidated balance sheets until all contingencies are resolved and the grant is determined to be realized.

### *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.

## 3. Capitalized Technology and Content Development Costs

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

	June 30, 2017		(in thousands)		December 31, 2016		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	
Capitalized technology costs	\$ 14,491	\$ (9,305)	\$ 5,186	\$ 12,988	\$ (7,822)	\$ 5,166	
Capitalized technology costs in process	6,615		6,615	4,112		4,112	
Total capitalized technology costs	21,106	(9,305)	11,801	17,100	(7,822)	9,278	
	38,058	(18,001)	20,057	33,353	(15,367)	17,986	

Edgar Filing: 2U, Inc. - Form 10-Q

Capitalized content development costs										
Capitalized content development costs in process	5,544			5,544	4,603			4,603		
Total capitalized content development costs	43,602	(18,001)		25,601	37,956	(15,367)		22,589		
Capitalized technology and content development costs	\$ 64,708	\$ (27,306)	\$	37,402	\$ 55,056	\$ (23,189)	\$	31,867		

Table of Contents

Amortization expense related to capitalized technology was \$0.8 million and \$0.5 million for the three months ended June 30, 2017 and 2016, respectively. Amortization expense related to capitalized technology was \$1.5 million and \$1.0 million for the six months ended June 30, 2017 and 2016, respectively.

The Company recorded amortization expense related to capitalized content development costs of \$1.8 million and \$1.4 million for the three months ended June 30, 2017 and 2016, respectively. The Company recorded amortization expense related to capitalized content development costs of \$3.5 million and \$2.6 million for the six months ended June 30, 2017 and 2016, respectively.

As of June 30, 2017, the estimated future amortization expense for the capitalized technology and content development costs placed in service is as follows (in thousands):

2017	\$	4,704
2018		8,368
2019		6,378
2020		3,785
2021		1,845
Thereafter		163
Total	\$	25,243

#### 4. Commitments and Contingencies

##### *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.

##### *Operating Leases*

The Company leases office facilities under non-cancelable operating leases in Maryland, New York, California, Colorado, North Carolina, Virginia and Hong Kong. In February 2017, the Company signed a lease for new office space in Brooklyn, New York, which is expected to be occupied beginning in 2018. The lease covers three floors totaling approximately 80,000 square feet, requires total future minimum lease payments of approximately \$51.8 million and will expire

approximately eleven years and nine months after the July 1, 2017 lease commencement date. Related to this lease, the Company could be eligible for certain state and local incentives that are dependent on construction build, employment levels, the Company's taxable income and other factors. The Company is in the process of applying for such eligibility, but is not currently able to assess the potential benefit these incentives may yield over the lease term. The Company also leases office equipment under non-cancelable leases.

*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. During the six months ended June 30, 2017, the Company entered into new agreements with certain of its clients for contract extensions and various marketing and other rights that, as of June 30, 2017, require future fixed payments totaling \$4.8 million, the majority of which were paid in July 2017.

Table of Contents

**5. Debt**

*Line of Credit*

In June 2017, the Company and Comerica amended its credit agreement for a \$25.0 million revolving line of credit pursuant to which, among other things, Comerica consented to the Company's acquisition of GetSmarter and the Company's formation of certain subsidiaries in connection therewith, and the parties extended the maturity date through July 31, 2017. On July 31, 2017, the Company further amended its credit agreement to extend the maturity date through September 29, 2017. No amounts were outstanding under this credit agreement as of June 30, 2017 or December 31, 2016. The Company intends to extend this agreement under comparable terms, prior to expiration.

Certain of the Company's operating lease agreements entered into prior to June 30, 2017 require security deposits in the form of cash or an unconditional, irrevocable letter of credit. As of June 30, 2017, the Company has entered into standby letters of credit totaling \$11.5 million as security deposits for the applicable leased facilities. Additionally, in June 2017, the Company entered into standby letters of credit totaling \$3.5 million in connection with two government grants, as described later in this Note. These letters of credit reduced the aggregate amount the Company may borrow under its revolving line of credit to \$10.0 million.

*Government Grants*

On June 22, 2017, the Company executed a conditional loan agreement and received financing from Prince George's County, Maryland that provides for a grant in the form of a forgivable loan of \$1.5 million. The financing was secured by a letter of credit pursuant to the Company's line of credit with Comerica Bank. The conditional loan obligation is recorded as *Deferred government grant obligations* on the condensed consolidated balance sheet. The proceeds from this loan are to be used in connection with the relocation of 2U's headquarters, leasehold improvements thereto and other purposes. The loan has a maturity date of June 22, 2027, and bears interest at a rate of 3% per annum. If 2U does not employ at least 650 employees at its Lanham headquarters at any time during the term of the loan period or otherwise defaults on the loan, the entire principal balance, plus accrued interest, will become due and payable. If 2U does not employ at least 1,300 employees at its Lanham headquarters by January 1, 2020, the Company will be required to repay a prorated portion of the loan (\$2,252 per employee, for every employee below 1,300), plus interest.

On June 27, 2017, 2U Harkins Road LLC (a wholly owned subsidiary of the Company) executed a loan agreement and received financing from the Department of Commerce (a principal department of the State of Maryland) that provides for a grant in the form of a forgivable loan of \$2.0 million. The financing was secured by a letter of credit pursuant to the Company's line of credit with Comerica Bank. The conditional loan obligation is recorded as *Deferred government grant obligations* on the condensed consolidated balance sheet. The proceeds from this loan are to be used in connection with the relocation of 2U's headquarters, leasehold improvements thereto and other purposes. The loan has a maturity date of December 31, 2026, and bears interest at a rate of 3% per annum. If 2U does not employ at least 650 employees at its Lanham headquarters at any time during the term of the loan period or otherwise defaults on the loan, the entire principal balance, plus accrued interest, will become due and payable. If 2U does not employ at least 1,600 employees at its Lanham headquarters by December 31, 2020, and at each December 31st thereafter through 2026, the Company will be required to repay a prorated portion of the loan (\$2,105 per employee, for every employee below 1,600), plus interest.

**6. Stockholders Equity**

As of June 30, 2017, 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, 2017, the Company had reserved a total of 10,988,222 of its authorized shares of common stock for future issuance as follows:

Outstanding stock options	5,095,909
Possible future issuance under 2014 Equity Incentive Plan	4,536,920
Outstanding restricted stock units	1,355,393
Total shares of common stock reserved for future issuance	10,988,222

The Compensation Committee of the Company's board of directors, acting under authority delegated from the board of directors, granted in July 2017 option awards to employees to purchase an aggregate of 34,019 shares of common stock at an exercise price of \$46.32 and restricted stock unit awards for an aggregate of 132,507 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

Table of Contents

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 2,357,579 and 2,288,820 on January 1, 2017 and 2016, respectively, pursuant to the automatic share reserve increase provision under the 2014 Plan.

*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,			Six Months Ended June 30,		
	2017	2016		2017	2016	
	(in thousands)					
Servicing and support	\$ 1,161	\$ 923	\$	\$ 1,856	\$ 1,574	\$
Technology and content development	897	654		1,543	1,106	
Program marketing and sales	430	355		772	613	
General and administrative	3,007	2,044		5,219	4,227	
Total stock-based compensation expense	\$ 5,495	\$ 3,976	\$	\$ 9,390	\$ 7,520	\$

*Stock Options*

The Company values stock options using the Black-Scholes-Merton option pricing model, which requires the input of subjective assumptions, including the risk-free interest rate, expected life of the option, expected stock price volatility and dividend yield. Prior to June 30, 2017, expected volatility was based on historical volatilities for publicly traded stock of comparable companies over the estimated expected life of the stock options. Effective June 30, 2017, expected volatility is based on the historical volatility of 2U common stock over the estimated expected life of the 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,			Six Months Ended June 30,		
2017	2016		2017	2016	

Edgar Filing: 2U, Inc. - Form 10-Q

Risk-free interest rate	2.0%	2.1%	1.3%	1.4%	2.0%	2.1%	1.3%	1.9%
Expected term (years)	6.00	6.08	5.75	6.08	6.00	6.08	5.75	6.08
Expected volatility	48.1%	48.2%	50%		48.1%	48.8%	50%	
Dividend yield	0%		0%		0%		0%	

The following is a summary of the stock option activity for the six months ended June 30, 2017:

	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, 2016	4,882,237	\$ 10.74	6.30	\$ 95,081
Granted	539,265	39.61	9.66	
Exercised	(271,579)	10.71	4.57	
Forfeited	(54,014)	21.99		
Expired				
Outstanding balance at June 30, 2017	5,095,909	13.68	6.19	169,396
Exercisable at June 30, 2017	3,636,372	7.79	5.18	142,287
Vested and expected to vest at June 30, 2017	5,095,909	13.68	6.19	169,396



Table of Contents

The total compensation cost related to the nonvested options not yet recognized as of June 30, 2017 was \$18.8 million and will be recognized over a weighted-average period of approximately 2.5 years.

The aggregate intrinsic value of the options exercised during the six months ended June 30, 2017 and 2016 was \$8.6 million and \$10.5 million, respectively.

***Restricted Stock Units***

The following is a summary of restricted stock unit activity for the six months ended June 30, 2017:

	<b>Number of Restricted Stock Units</b>	<b>Weighted- Average Grant Date Fair Value</b>
Outstanding balance at December 31, 2016	1,412,934	\$ 20.60
Granted	467,626	39.60
Vested	(469,324)	18.64
Forfeited	(55,843)	25.07
Outstanding balance at June 30, 2017	1,355,393	27.65

The total compensation cost related to the nonvested restricted stock units not yet recognized as of June 30, 2017 was \$33.3 million and will be recognized over a weighted-average period of approximately 2.6 years.

***Employee Stock Purchase Plan***

On June 5, 2017, 2U's stockholders voted upon and approved the Company's 2017 Employee Stock Purchase Plan (the "ESPP"). The ESPP provides for (i) consecutive six-month offering periods (commencing each January 1 and July 1) and (ii) that the purchase price for shares of 2U common stock purchased under the ESPP will not be less than 85% of the fair market value of the Company's common stock on the purchase date. The Compensation Committee of the Company's Board of Directors may exercise its discretion, subject to certain conditions, to determine that the purchase price will be 85% of the lesser of the fair market value of 2U's common stock on the purchase date or the fair market value of 2U's common stock on the first day of the offering period. The first offering period is expected to begin on January 1, 2018, and will end on June 30, 2018. Eligible employees will be able to select a rate of payroll deduction between 1% and 15% of their salary or wage compensation received from the Company as in effect at the start of the offering period, subject to a maximum payroll deduction per calendar year of \$25,000. The ESPP is intended to qualify as an employee stock purchase plan under Section 423 of the Internal Revenue Code. A maximum of 1,000,000 shares of 2U's common stock may be issued under the ESPP, subject to adjustments for certain capital transactions.

**8. Net Loss per Share**

## Edgar Filing: 2U, Inc. - Form 10-Q

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, 2017 and 2016:

	Three and Six Months Ended June 30,	
	2017	2016
Stock options	5,095,909	5,358,182
Restricted stock units	1,355,393	1,421,372

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
<b>Numerator (in thousands):</b>				
Net loss	\$ (11,754)	\$ (8,337)	\$ (15,193)	\$ (11,717)
<b>Denominator:</b>				
Weighted-average shares of common stock outstanding, basic and diluted	47,668,397	46,494,464	47,454,059	46,226,117
Net loss per share, basic and diluted	\$ (0.25)	\$ (0.18)	\$ (0.32)	\$ (0.25)

Table of Contents

**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, with the exception of a 1.2 billion South African rand denominated restricted cash balance at June 30, 2017, which was held in connection with the Company s acquisition of GetSmarter, as further discussed in Note 10 below.

**10. Subsequent Events**

On July 1, 2017, the Company, through a wholly owned subsidiary ( 2U South Africa ), completed its acquisition of all of the outstanding equity interests of GetSmarter pursuant to a Share Sale Agreement, dated as of May 1, 2017 (the Share Sale Agreement ), as amended by an Addendum, dated as of June 29, 2017, for a purchase price of approximately \$103.0 million in cash. The purchase price is subject to post-closing adjustments pursuant to the terms of the Share Sale Agreement. In addition, 2U South Africa agreed to pay a potential earn out payment of up to \$20.0 million, subject to the achievement of certain financial milestones in calendar years 2017 and 2018. Under the terms of the Share Sale Agreement, 2U has issued restricted stock units for shares of common stock, par value \$0.001 per share, of the Company to certain employees and officers of GetSmarter. These awards are subject to the 2014 2U, Inc. Equity Incentive Plan and will vest over either a two (2) or four (4) year period. As a result of the transaction, GetSmarter became an indirect wholly owned subsidiary of the Company.

Table of Contents

**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, 2016. 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 this Quarterly Report on Form 10-Q and in our Annual Report on Form 10-K for the year ended December 31, 2016, 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.*

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, 2016, which are included in our Annual Report on Form 10-K filed with the SEC on February 24, 2017.

**Overview**

We are a leading provider of cloud-based software-as-a-service, or SaaS, technology and technology-enabled services that enable leading nonprofit colleges and universities to deliver their degree programs at scale to students anywhere. Our SaaS technology consists of an innovative online learning environment, where our clients deliver their high-quality educational content to students in a live, intimate and engaging setting. We also provide a comprehensive suite of integrated applications, including a content management system and a customer relationship management system, that serve as the back-end infrastructure of the programs we enable. This technology is fused with technology-enabled services, including student acquisition services, content development services, student and faculty support, clinical placement services, and admissions applications advising services. This suite of technology tightly integrated with technology-enabled services, optimized with data analysis and machine learning techniques, provides a comprehensive set of capabilities that would otherwise require the purchase of multiple, disparate point solutions, and 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.

**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 first two programs with the University of Southern California, which are our longest running programs, which we launched in 2009 and 2010, and our programs with Simmons College, which launched between 2013 and 2016. For the three months ended June 30, 2017 and 2016, 29% and 36%, respectively, of our revenue was derived from the first two University of Southern California programs. For the three months ended June 30, 2017 and 2016, 19% and 18%, respectively, of our revenue was derived from the Simmons College programs. For the six months ended June 30, 2017 and 2016, 29% and 37%, respectively, of our revenue was derived from the first two University of Southern California

Table of Contents

programs. For the six months ended June 30, 2017 and 2016, 18% and 17%, respectively, of our revenue was derived from the Simmons College programs. We expect that the first two programs with the University of Southern California and our programs with Simmons College will continue to account for a large portion of our revenue even though that portion should decline as other client programs become more mature and achieve higher enrollment levels.

***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 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 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 approximately 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 over time related to 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 current period expense than is implied by the multiple of current period revenue to current period program marketing and sales expense as expressed in our financial statements. 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.

Table of Contents

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.

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

*Second Quarter 2017 Highlights*

- Revenue was \$65.0 million, an increase of 32.3% from \$49.1 million in the second quarter of 2016.
- Net loss was \$(11.8) million, or \$(0.25) per share, compared to \$(8.3) million or \$(0.18) per share, in the second quarter of 2016.
- Adjusted EBITDA loss was \$(1.5) million, compared to \$(2.1) million in the second quarter of 2016.

*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.

In addition to providing access to our SaaS technology, 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



## Edgar Filing: 2U, Inc. - Form 10-Q

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.

Revenue for the three months ended June 30, 2017 was \$65.0 million, an increase of \$15.9 million, or 32.3%, from \$49.1 million for the same period of 2016. The increase was primarily attributable to a 27.0% increase in period-over-period full course equivalent enrollments in our client programs, from 18,823 for the three months ended June 30, 2016 to 23,903 for the three months ended June 30, 2017. Of the increase in full course equivalent enrollments, 971, or 19.1%, were attributable to client programs launched during the 12 months ended June 30, 2017.

Revenue for the six months ended June 30, 2017 was \$129.8 million, an increase of \$33.3 million, or 34.5%, from \$96.5 million for the same period of 2016. The increase was primarily attributable to a 30.7% increase in period-over-period full course equivalent enrollments in our client programs, from 36,532 for the six months ended June 30, 2016 to 47,760 for the six months ended June 30, 2017. Of the increase in full course equivalent enrollments, 1,779, or 15.8%, were attributable to client programs launched during the 12 months ended June 30, 2017.

### *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

Table of Contents

(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.

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 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 early-2014 grants.

*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 our SaaS technology for our clients and their students.

Servicing and support costs for the three months ended June 30, 2017 were \$13.5 million, an increase of \$3.2 million, or 31.2%, from \$10.3 million for the same period of 2016. This increase was due primarily to higher cash compensation costs of \$1.5 million, as we increased our headcount in this area by 9% to serve a growing number of students and faculty in existing and new client programs. Additionally, \$1.1 million of the increase related to student immersion courses and on-campus initiatives, in-program field placements, rent expense and travel and related expenses. The remainder of the increase in servicing and support costs related to other costs to support our program marketing efforts. As a percentage of revenue, servicing and support costs decreased from 20.9% for the three months ended June 30, 2016 to 20.7% for the same period of 2017, as revenue grew at a higher rate than the increase in expense.

Servicing and support costs for the six months ended June 30, 2017 were \$24.4 million, an increase of \$4.6 million, or 23.3%, from \$19.8 million for the same period of 2016. This increase was due primarily to higher cash compensation costs of \$2.9 million, as we increased our headcount in this area by 10% to serve a growing number of students and faculty in existing and new client programs. Additionally, \$0.9 million of the increase related to student immersion courses and on-campus initiatives, in-program field placements, rent expense and travel and related expenses. The remainder of the increase in servicing and support costs related to other costs to support our program marketing efforts. As a percentage of revenue, servicing and support costs decreased from 20.5% for the six months ended June 30, 2016 to 18.8% for the same period of 2017, as revenue grew at a higher rate than the increase in expense.

*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 our SaaS technology, 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 our SaaS technology in a cloud environment.

Technology and content development costs for the three months ended June 30, 2017 were \$11.1 million, an increase of \$2.3 million, or 26.0%, from \$8.8 million for the same period of 2016. This increase was due primarily to higher amortization expense associated with our capitalized technology and content development costs of \$0.8 million, due to the larger number of courses that have been developed for our client programs. Additionally, cash compensation costs (net of amounts capitalized for technology and content development) and travel and related expenses increased \$0.8 million, as we increased our headcount in this area by 24% to support the launch of new client programs and the scaling of existing programs. The remainder of the increase related to cloud-based hosting services, non-cash stock-based compensation costs and other technology and content development costs. As a percentage of revenue, technology and content development costs decreased from 18.0% for the three months ended June 30, 2016 to 17.1% for the same period of 2017, as revenue grew at a higher rate than the increase in expense.

Technology and content development costs for the six months ended June 30, 2017 were \$20.3 million, an increase of \$4.2 million, or 26.2%, from \$16.1 million for the same period of 2016. This increase was due primarily to higher amortization expense associated with our capitalized technology and content development costs of \$1.6 million, due to the larger number of courses that have been developed for our client programs. Additionally, cash compensation costs (net of amounts capitalized for technology and content development) and travel and related expenses increased \$1.5 million, as we increased our headcount in this area by 28% to support the launch of new client programs and the scaling of existing programs. The remainder of the increase in technology and content development costs related to cloud-based hosting services and other technology and content development costs. As a percentage of revenue, technology and content development costs decreased from 16.7% for the six months ended June 30, 2016 to 15.7% for the same period of 2017, as revenue grew at a higher rate than the increase in expense.

Table of Contents

*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.

Program marketing and sales expense for the three months ended June 30, 2017 was \$37.2 million, an increase of \$9.7 million, or 35.5%, from \$27.5 million for the same period of 2016. This increase was due primarily to higher direct internet marketing costs to acquire students for our clients programs of \$5.9 million. Additionally, cash compensation costs and travel and related expenses increased by \$2.6 million, as we increased our headcount in this area by 19% to acquire students for, and drive revenue growth in, new client programs. The remainder of the increase in program marketing and sales expense primarily related to depreciation and amortization of long-lived assets, rent expense and other costs to support our programs marketing efforts. As a percentage of revenue, program marketing and sales expense increased from 55.9% for the three months ended June 30, 2016 to 57.4% for the same period of 2017, reflecting a higher year-over-year percentage increase in revenue than the increase in expense.

Program marketing and sales expense for the six months ended June 30, 2017 was \$71.9 million, an increase of \$20.8 million, or 40.6%, from \$51.1 million for the same period of 2016. This increase was due primarily to a \$13.6 million increase in direct internet marketing costs to acquire students for our clients programs. Additionally, cash compensation costs and travel and related costs were \$5.0 million higher, as we increased our headcount in this area by 22% to acquire students for, and drive revenue growth in, new client programs. The remainder of the increase in program marketing and sales expense primarily related to depreciation and amortization of long-lived assets, rent expense and other costs to support our programs marketing efforts. As a percentage of revenue, program marketing and sales expense increased from 52.9% for the three months ended June 30, 2016 to 55.4% for the same period of 2017, reflecting a higher year-over-year percentage increase in revenue than the increase in expense.

*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.

General and administrative expense for the three months ended June 30, 2017 was \$13.9 million, an increase of \$3.0 million, or 27.3%, from \$10.9 million for the same period of 2016. This increase was due primarily to higher cash compensation costs of \$2.2 million and an additional \$1.0 million in non-cash stock-based compensation costs as we increased our headcount in this area by 16% to support our growing business. These increases were partially offset by decreases in other general and administrative expenses. As a percentage of revenue, general and administrative expense decreased from 22.3% for the three months ended June 30, 2016 to 21.4% for the same period of 2017, reflecting a higher year-over-year percentage increase in revenue than the increase in expense.

General and administrative expense for the six months ended June 30, 2017 was \$27.6 million, an increase of \$6.2 million, or 29.0%, from \$21.4 million for the same period of 2016. This increase was due primarily to higher cash compensation costs of \$3.1 million and non-cash stock-based compensation costs of \$1.0 million as we increased our headcount in this area by 18% to support our growing business. Additionally, consulting and other professional services expenses increased by \$1.7 million, primarily driven by our acquisition of GetSmarter and the integration of our enterprise resource planning system. As a percentage of revenue, general and administrative expense decreased from

## Edgar Filing: 2U, Inc. - Form 10-Q

22.2% for the six months ended June 30, 2016 to 21.3% for the same period of 2017, reflecting a higher year-over-year percentage increase in revenue than the increase in expense.

### *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.

Total other income (expense) for the three months ended June 30, 2017 was an expense of \$1.0 million, a change of \$1.1 million, from other income of \$0.1 million for the same period of 2016. This change was driven primarily by a \$1.0 million foreign currency

Table of Contents

translation loss recorded on a South African rand denominated restricted cash balance held in connection with the acquisition of GetSmarter.

Total other income (expense) for the six months ended June 30, 2017 was an expense of \$0.8 million, a change of \$0.9 million, from other income \$0.1 million for the same period of 2016. This change was driven primarily by a \$1.0 million foreign currency translation loss recorded on a South African rand denominated restricted cash balance held in connection with the acquisition of GetSmarter.

***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, 2017 and 2016.

***Consolidated Statements of Operations as a Percentage of Revenue***

The following table sets forth selected consolidated statements of operations data as a percentage of revenue for each of the periods indicated.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
Revenue	100.0%	100.0%	100.0%	100.0%
Costs and expenses:				
Servicing and support	20.7	20.9	18.8	20.5
Technology and content development	17.1	18.0	15.7	16.7
Program marketing and sales	57.4	55.9	55.4	52.9
General and administrative	21.4	22.3	21.3	22.2
Total costs and expenses	116.6	117.1	111.2	112.3
Loss from operations	(16.6)	(17.1)	(11.2)	(12.3)
Other income (expense):				
Interest income	0.1	0.2	0.2	0.2
Interest expense	0.0	0.0	0.0	0.0
Foreign currency loss	(1.6)		(0.8)	
Total other income (expense)	(1.5)	0.2	(0.6)	0.2
Net loss	(18.1)%	(16.9)%	(11.8)%	(12.1)%

**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

loss from operations 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 with our solutions 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.

Table of Contents

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
Platform revenue retention rate	127.4%	134.2%	128.8%	123.7%
Number of programs included in comparison (1)	18	15	17	12

(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 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,	
	2017	2016	2017	2016
Full course equivalent enrollments in our clients programs	23,903	18,823	47,760	36,532
Average revenue per full course equivalent enrollment in our clients programs	\$ 2,719	\$ 2,609	\$ 2,718	\$ 2,643

**Adjusted EBITDA**



## Edgar Filing: 2U, Inc. - Form 10-Q

Adjusted EBITDA represents our earnings before net interest income (expense), taxes, depreciation and amortization, foreign currency gains or losses and stock-based compensation expense. 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:

Table of Contents

- 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:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
	(in thousands)			
Net loss	\$ (11,754)	\$ (8,337)	\$ (15,193)	\$ (11,717)
Adjustments:				
Interest income	(53)	(91)	(249)	(183)
Interest expense	1	9	1	35
Foreign currency loss	1,031		1,031	
Depreciation and amortization expense	3,783	2,377	7,431	4,526
Stock-based compensation expense	5,495	3,976	9,390	7,520
Total adjustments	10,257	6,271	17,604	11,898
Adjusted EBITDA (loss)	\$ (1,497)	\$ (2,066)	\$ 2,411	\$ 181

**Liquidity and Capital Resources***Sources of Liquidity*

In June 2017, we amended our credit agreement with Comerica for a \$25.0 million revolving line of credit pursuant to which, among other things, Comerica consented to our acquisition of GetSmarter and our formation of certain subsidiaries in connection therewith, and we extended the maturity date through July 31, 2017. On July 31, 2017, we further amended our credit agreement to extend the maturity date through September 29, 2017. No amounts were outstanding under this credit agreement as of June 30, 2017 or December 31, 2016.

Certain of our operating lease agreements entered into prior to June 30, 2017 require security deposits in the form of cash or an unconditional, irrevocable letter of credit. As of June 30, 2017, we have entered into standby letters of credit totaling \$11.5 million, as security deposits for the applicable leased facilities and totaling \$3.5 million in connection with government grants. These letters of credit reduced the aggregate amount we may borrow under our revolving line of credit to \$10.0 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, 2017 and December 31, 2016, our adjusted quick ratios were 2.07 and 5.43, respectively.

Table of Contents

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.

*Cash Flows*

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

	Six Months Ended June 30,	
	2017	2016
	(in thousands)	
Cash (used in) provided by:		
Operating activities	\$ (8,137)	\$ 11,507
Investing activities	(26,257)	(8,608)
Financing activities	5,117	1,623

*Operating Activities*

For the six months ended June 30, 2017, net cash used in operating activities of \$8.1 million consisted of a net loss of \$15.2 million and a \$10.8 million net cash outflow from changes in working capital, partially offset by \$17.9 million in non-cash items. The decrease in cash resulting from changes in working capital consisted of a \$15.6 million increase in accounts receivable and a \$7.5 million increase in payments to clients, partially offset by a \$4.3 million increase in accrued expenses and other liabilities, a \$4.2 million increase in deferred revenue and other changes to working capital of \$3.8 million. Non-cash items consisted of non-cash stock-based compensation charges of \$9.4 million, depreciation and amortization expense of \$7.5 million and a \$1.0 million foreign currency translation loss recorded on a South African rand denominated restricted cash balance held in connection with the acquisition of GetSmarter.

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.

*Investing Activities*

For the six months ended June 30, 2017, net cash used in investing activities of \$26.3 million consisted of \$15.5 million of purchases of property and equipment, primarily related to leasehold improvement expenditures for our new office operating leases. Additionally, costs related to internal-use software and content developed to support a greater number of launched programs were \$10.8 million.

For the six months ended June 30, 2016, net cash used in investing activities of \$8.6 million consisted primarily of costs related to internal-use software and content developed to support a greater number of launched programs, and equipment.

*Financing Activities*

For the six months ended June 30, net cash provided by financing activities was \$5.1 million, consisting of \$3.5 million of proceeds from government grants awarded to us in the form of forgivable loans, \$2.9 million of proceeds received from the exercise of stock options, partially offset by \$1.3 million of cash used for the payment of employee withholding taxes related to net settlement releases of restricted stock units.

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.

Table of Contents

**Operating and Capital Expenditure Requirements**

During the six months ended June 30, 2017, we had new capital asset additions of \$31.6 million, which was comprised of \$15.6 million of leasehold improvements, \$10.5 million in capitalized technology and content development costs and \$5.5 million of other property and equipment. The \$31.6 million increase consisted of \$26.3 million in cash capital expenditures, with the remainder primarily comprised of landlord funded leasehold improvements. For the full year of 2017, we expect new capital asset additions of approximately \$64 to \$69 million, of which approximately \$11 to \$13 million will be funded by landlord leasehold improvement allowances.

**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 (with letters of credit reducing the aggregate amount we may borrow to \$10.0 million) and no amounts were outstanding as of June 30, 2017.

See Note 4 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.

**Recent Accounting Pronouncements**

Refer to Note 1 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**

There have been no material changes to market risk from the information provided in Part II, Item 7A of our Annual Report on Form 10-K, filed with the SEC on February 24, 2017.

**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 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, 2017.

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

During the first quarter of 2017, we finished the migration of our Human Capital Management and payroll systems to a single enterprise resource planning ( ERP ) system called Workday and in the second quarter of 2017 we finished the migration of our accounting and financial reporting systems to Workday. This two-phase ERP system implementation impacts various internal processes and controls for business activities within human resources, payroll and accounting, as well as financial reporting. While the Company believes that this new system and the related changes to internal controls will ultimately strengthen its internal controls over financial reporting, there are inherent risks in implementing any ERP system, and the Company will continue to evaluate and test control changes in order to provide certification on the effectiveness, in all material respects, of its internal controls over financial reporting for the year ending December 31, 2017.

Except for our implementation of Workday as described above, there were no changes in our internal control over financial reporting that occurred during the second quarter ended June 30, 2017 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting. The Company has modified and will continue to modify its internal controls relating to its business and financial processes throughout the entire ERP system implementation.

Table of Contents

**PART II. OTHER INFORMATION**

**Item 1. Legal Proceedings**

The information required by this Item is incorporated herein by reference to Note 4 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, 2016, which was filed with the SEC on February 24, 2017, remain current in all material respects, except for the additional risk factors below. These risks 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.

**Risks Relating to the GetSmarter Acquisition and the Combined Company**

*Combining the two companies may be more difficult, costly or time consuming than expected and the anticipated strategic benefits of the GetSmarter acquisition may not be realized.*

The success of the GetSmarter acquisition, including anticipated strategic benefits, will depend, in part, on our ability to successfully combine and integrate our business with the business of GetSmarter.

The GetSmarter acquisition will involve the integration of GetSmarter's business with our existing business, which is a complex, costly and time-consuming process. It is possible that the integration process could result in material challenges, including, without limitation:

- the diversion of management's attention from ongoing business concerns and performance shortfalls at one or both of the companies as a result of the devotion of management's attention to the GetSmarter acquisition;
- managing a larger combined international company;



- maintaining employee morale and retaining key management and other employees;
- the possibility of faulty assumptions underlying expectations regarding the integration process;
- retaining existing business and operational relationships and attracting new business and operational relationships;
- consolidating corporate and administrative infrastructures and eliminating duplicative operations and inconsistencies in standards, controls, procedures and policies;
- coordinating geographically separate organizations;
- unanticipated issues in integrating information technology, communications and other systems; and
- unforeseen expenses associated with integration of the GetSmarter business.

Many of these factors will be outside of the combined company's control and any one of them could result in delays, increased costs, decreases in revenues and diversion of management's time and energy, which could materially affect the combined company's financial position, results of operations and cash flows.

If we experience difficulties with the integration process, the anticipated benefits of the acquisition may not be realized fully or at all, or may take longer to realize than expected. In addition, the actual strategic benefits of the acquisition could be less than anticipated.

Table of Contents

***The future results of the combined company may be adversely impacted if the combined company does not effectively manage its expanded operations following the completion of the GetSmarter acquisition.***

Following the completion of the acquisition, the size of the combined company's business may be significantly larger than the current size of either our or GetSmarter's respective businesses. The combined company's ability to successfully manage this expanded business will depend, in part, upon management's ability to design and implement strategic initiatives that address not only the integration of two discrete companies in different geographic locations, but also the increased scale and scope of the combined business with its associated increased costs and complexity. The combined company may not be successful and may not realize the expected operating leverage and strategic benefits currently anticipated from the GetSmarter acquisition.

***The combined company incurred substantial expenses related to the completion of the acquisition of GetSmarter and expects to incur additional expense in connection with the integration of 2U and GetSmarter.***

We and GetSmarter have incurred, and expect to continue to incur, a number of non-recurring costs associated with the GetSmarter acquisition and combining the operations of the two companies. The substantial majority of non-recurring expenses will be comprised of transaction costs related to the GetSmarter acquisition.

We also will incur costs related to formulating and implementing integration plans, including facilities and systems consolidation costs and employment-related costs. We continue to assess the magnitude of these costs, and additional unanticipated costs may be incurred in the integration of the two companies' businesses. Although we expect that the realization of other efficiencies related to the integration of the businesses should allow us to offset integration-related costs over time, this net benefit may not be achieved in the near term, or at all.

***GetSmarter may underperform relative to our expectations.***

GetSmarter may not be able to achieve the levels of revenue, earnings or operating efficiency that we expected it to. GetSmarter's business and financial performance are subject to certain risks and uncertainties, including, among others, the following: (i) the risk of the loss of, or changes to, its relationships with its customers; (ii) its ability to acquire a new customers and expand short courses with current customers; (iii) its ability to continue to acquire prospective students for its current short courses; (iv) the acceptance, adoption and growth of online learning, particularly via short course certificates, by colleges and universities, faculty, students, employers, accreditors and state and federal licensing bodies, if applicable; and (v) the lack of predictability and visibility and the non-recurring nature of its business model. GetSmarter may be unable to achieve the same growth, revenues and earnings that GetSmarter has achieved in the past.

***The combined company may underperform relative to our expectations.***

If GetSmarter underperforms relative to our expectations, we may not be able to maintain the levels of revenue, earnings or operating efficiency that we and GetSmarter have achieved or might achieve separately. In addition, due to the short term nature and lower price point of GetSmarter's short course certificates and the shorter contractual terms with its clients, we may not be able to reliably forecast or predict the

impact that GetSmarter will have on the combined company's revenue or other aspects of our results of operations.

*Uncertainties associated with the GetSmarter acquisition may cause the departure of management personnel and other key employees of GetSmarter or us, which could adversely affect the future business and operations of the combined company.*

We and GetSmarter are dependent upon the experience and industry knowledge of our respective officers and other key employees to execute our respective business plans. The combined company's success after the GetSmarter acquisition will depend in part upon its ability to retain key management personnel and other key employees of 2U and GetSmarter. Current and prospective employees of 2U and GetSmarter may experience uncertainty about their future roles with the combined company, which may materially adversely affect the ability of each of 2U and GetSmarter to attract and retain key personnel after the acquisition which could adversely impact operations of the combined company.

*GetSmarter's operations in South Africa expose us to risks that could have an adverse effect on our business.*

As of June 30, 2017, GetSmarter employed approximately 300 employees in South Africa, and it expects to continue adding personnel. GetSmarter may incur costs complying with labor laws, rules and regulations in South Africa, including laws that regulate work time, provide for mandatory compensation in the event of termination of employment for operational reasons, and impose monetary penalties for non-compliance with administrative and reporting requirements in respect of affirmative action policies. GetSmarter's reliance on a workforce in South Africa also exposes us to disruptions in the business, political, and economic environment in that region. Maintenance of a stable political environment is important to GetSmarter's operations, and terrorist attacks and acts of violence or war may directly affect our physical facilities and workforce or contribute to general instability. GetSmarter's operations in South Africa require us to comply with complex local laws and regulatory requirements and expose us to foreign

Table of Contents

currency exchange rate risk. The economy of South Africa in the past has been, and in the future may continue to be, characterized by rates of inflation and interest rates that are substantially higher than those prevailing in the United States, which could increase our South-African based costs and decrease our operating margins. GetSmarter's operations may also subject us to trade restrictions, exchange control limitations, reduced or inadequate protection for intellectual property rights, security breaches, and other factors that may adversely affect our business. Negative developments in any of these areas could increase our costs of operations or otherwise harm our business.

*The market price of our common stock may decline as a result of the GetSmarter acquisition.*

The market price of our common stock may decline as a result of the GetSmarter acquisition if, among other things, we are unable to achieve the expected growth in revenue, or if the strategic benefits are not realized or if the transaction costs related to the GetSmarter acquisition are greater than expected. The market price of our common stock also may decline if we do not achieve the perceived benefits of the GetSmarter acquisition as rapidly or to the extent anticipated by financial or industry analysts or if the effect of the GetSmarter acquisition on our financial results is not consistent with the expectations of financial or industry analysts.

**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**

<b>Exhibit Number</b>	<b>Description</b>	<b>Form</b>	<b>File No.</b>	<b>Exhibit Number</b>	<b>Filing Date</b>	<b>Filed Herewith</b>
2.1	Share Sale Agreement, by and among a wholly owned subsidiary of the Registrant, K2017143886 South Africa Proprietary Limited, Get Educated International Proprietary Limited ( GetSmarter ), the shareholders of GetSmarter, and Samuel Edward Paddock, as the Seller s Representative.	10-Q	001-36376	2.1	May 4, 2017	
2.2	Addendum to Share Sale Agreement, by and among a wholly owned subsidiary of the Registrant, K2017143886 South Africa Proprietary Limited, Get Educated International Proprietary Limited ( GetSmarter ), the shareholders of GetSmarter, and Samuel Edward Paddock, as the Seller s Representative.	8-K	001-36376	2.1	July 3, 2017	
3.1	Amended and Restated Certificate of Incorporation of the Registrant.	8-K	001-36376	3.1	April 4, 2014	
3.2	Amended and Restated Bylaws of the Registrant.	8-K	001-36376	3.2	April 4, 2014	

Table of Contents

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.	X
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.	X
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.	X
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.	X
101.INS	XBRL Instance Document.	X
101.SCH	XBRL Taxonomy Extension Schema Document.	X
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document.	X
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document.	X
101.LAB	XBRL Taxonomy Extension Label Linkbase Document.	X
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document.	X

---

(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 7, 2017

By:

*/s/ Christopher J. Paucek*  
Christopher J. Paucek  
Chief Executive Officer

August 7, 2017

By:

*/s/ Catherine A. Graham*  
Catherine A. Graham  
Chief Financial Officer