2U, Inc.
Form 10-Q
August 06, 2014
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2014

or

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

For the transition period from to

Commission File Number: 001-36376

2U, INC.

(Exact name of registrant as specified in its charter)

Delaware	**26-2335939**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
8201 Corporate Drive, Suite 900 **Landover, MD**	**20785**
(Address of principal executive offices)	(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 and 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. S 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). S Yes £ No

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

Large accelerated filer	o	Accelerated filer	o	Non-accelerated filer	x	Smaller reporting company	o

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

As of August 4, 2014, there were 40,266,479 shares of Common Stock, par value $0.001 per share, outstanding.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

2U, Inc.

Condensed Consolidated Balance Sheets

(in thousands, except share and per share amounts)

	December 31, 2013	June 30, 2014 (unaudited)
Assets		
Current assets:		
Cash and cash equivalents	$ 7,012	$ 104,762
Accounts receivable, net	1,835	655
Advance to clients, current	581	
Prepaid expenses	1,763	2,773
Total current assets	11,191	108,190
Property and equipment, net	5,231	5,741
Capitalized content development costs, net	8,904	11,034
Advance to clients, non-current		1,150
Other non-current assets	3,326	1,745
Total assets	$ 28,652	$ 127,860
Liabilities, redeemable convertible preferred stock and stockholders equity (deficit)		
Current liabilities:		
Accounts payable	$ 5,089	$ 4,085
Accrued expenses and other current liabilities	12,025	13,326
Deferred revenue	1,266	12,396
Refunds payable	1,831	2,027
Total current liabilities	20,211	31,834
Rebate reserve	1,571	1,566
Other non-current liabilities	847	642
Total liabilities	22,629	34,042
Commitments and contingencies (Note 6)		
Redeemable convertible preferred stock:		
Redeemable convertible Series A preferred stock, $0.001 par value, 10,033,976 shares authorized, issued and outstanding as of December 31, 2013; 0 shares authorized, issued and outstanding as of June 30, 2014	12,384	
Redeemable convertible Series B preferred stock, $0.001 par value, 5,057,901 shares authorized, issued and outstanding as of December 31, 2013; 0 shares authorized, issued and outstanding as of June 30, 2014	22,210	
Redeemable convertible Series C preferred stock, $0.001 par value, 4,429,601 shares authorized, issued and outstanding as of December 31, 2013; 0 shares authorized, issued and outstanding as of June 30, 2014	32,405	
Redeemable convertible Series D preferred stock, $0.001 par value, 4,069,352 shares authorized, 3,979,730 shares issued and outstanding as of December 31, 2013; 0 shares authorized, issued and outstanding as of June 30, 2014	31,048	

Total redeemable convertible preferred stock		98,047		
Stockholders equity (deficit):				
Preferred stock, $0.001 par value, 0 shares authorized, issued and outstanding as of December 31, 2013; 5,000,000 shares authorized, 0 shares issued and outstanding as of June 30, 2014				
Common stock, $0.001 par value, 60,000,000 shares authorized, 7,629,133 shares issued and outstanding as of December 31, 2013; 200,000,000 shares authorized, 40,259,230 shares issued and outstanding as of June 30, 2014		8		40
Additional paid-in capital		7,817		211,272
Accumulated deficit		(99,849)		(117,494)
Total stockholders equity (deficit)		(92,024)		93,818
Total liabilities, redeemable convertible preferred stock and stockholders equity (deficit)	$	28,652	$	127,860

See accompanying notes to the condensed consolidated financial statements.

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2U, Inc.

Condensed Consolidated Statements of Operations

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

	Three Months Ended June 30, 2013	Three Months Ended June 30, 2014	Six Months Ended June 30, 2013	Six Months Ended June 30, 2014
Revenue	$ 18,691	$ 24,744	$ 37,825	$ 51,076
Costs and expenses:				
Servicing and support	5,656	7,000	10,674	13,248
Technology and content development	4,596	5,818	7,831	11,492
Program marketing and sales	13,695	16,710	25,465	31,951
General and administrative	3,654	5,708	6,525	11,144
Total costs and expenses	27,601	35,236	50,495	67,835
Loss from operations	(8,910)	(10,492)	(12,670)	(16,759)
Other income (expense):				
Interest expense	5	(134)	13	(918)
Interest income	10	31	16	32
Total other income (expense)	15	(103)	29	(886)
Loss before income taxes	(8,895)	(10,595)	(12,641)	(17,645)
Income tax expense				
Net loss	(8,895)	(10,595)	(12,641)	(17,645)
Preferred stock accretion	(87)	(2)	(174)	(89)
Net loss attributable to common stockholders	$ (8,982)	$ (10,597)	$ (12,815)	$ (17,734)
Net loss per share attributable to common stockholders, basic and diluted	$ (1.21)	$ (0.27)	$ (1.73)	$ (0.75)
Weighted average common shares outstanding, basic and diluted	7,398,059	39,304,884	7,392,129	23,588,330

See accompanying notes to the condensed consolidated financial statements.

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2U, Inc.

Condensed Consolidated Statements of Changes in Stockholders Equity (Deficit)

(unaudited, in thousands, except share amounts)

	Common Stock Shares	Common Stock Amount	Additional Paid-In Capital	Accumulated Deficit	Total Stockholders Equity (Deficit)
Balance, December 31, 2013	7,629,133	$ 8	$ 7,817	$ (99,849)	$ (92,024)
Exercise of stock options	464,803		1,023		1,023
Grant of common stock	5,000		55		55
Accretion of issuance costs on redeemable convertible preferred stock			(89)		(89)
Stock-based compensation expense			3,239		3,239
Conversion of redeemable convertible preferred stock to common stock	23,501,208	23	98,113		98,136
Conversion of Series D warrant to common stock warrant			821		821
Issuance of common stock from initial public offering, net of issuance costs	8,626,377	9	100,293		100,302
Exercise of warrants to purchase common stock	32,709				
Net loss				(17,645)	(17,645)
Balance, June 30, 2014	40,259,230	$ 40	$ 211,272	$ (117,494)	$ 93,818

See accompanying notes to the condensed consolidated financial statements.

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2U, Inc.

Condensed Consolidated Statements of Cash Flows

(unaudited, in thousands)

	Six Months Ended June 30, 2013	Six Months Ended June 30, 2014
Cash flows from operating activities		
Net loss	$ (12,641)	$ (17,645)
Adjustments to reconcile net loss to net cash (used in) provided by operating activities:		
Depreciation and amortization	1,942	2,646
Stock-based compensation expense	1,068	3,239
Change in the fair value of the Series D redeemable convertible preferred stock warrant prior to conversion	(13)	695
Changes in operating assets and liabilities:		
Accounts receivable, net	(924)	1,180
Advances to clients		(569)
Prepaid expenses	(1,020)	(1,010)
Other assets	19	662
Accounts payable	(35)	(773)
Accrued expenses and other current liabilities	2,417	1,921
Deferred revenue	7,835	11,130
Refunds payable	173	196
Rebate reserve	44	(5)
Other liabilities	19	(25)
Net cash (used in) provided by operating activities	(1,116)	1,642
Cash flows from investing activities		
Expenditures for property and equipment	(1,668)	(1,720)
Capitalized content development cost expenditures	(2,045)	(3,476)
Other investing activities		(21)
Net cash used in investing activities	(3,713)	(5,217)
Cash flows from financing activities		
Proceeds from issuance of common stock, net of offering costs		100,302
Proceeds from exercise of stock options	69	1,023
Repurchase of common shares	(149)	
Proceeds from issuance of Series D redeemable convertible preferred stock, net of issuance costs	4,994	
Net cash provided by financing activities	4,914	101,325
Net increase in cash and cash equivalents	85	97,750
Cash and cash equivalents, beginning of period	25,190	7,012
Cash and cash equivalents, end of period	$ 25,275	$ 104,762
Supplemental disclosure of non-cash investing and financing activities		
Accretion of issuance costs on redeemable convertible preferred stock	$ 174	$ 89
Accrued capital expenditures	242	278
Deferred offering costs included in accounts payable and accrued expenses		144
Common stock granted in exchange for consulting services received		55

See accompanying notes to the condensed consolidated financial statements.

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2U, Inc.

Notes to Condensed Consolidated Financial Statements

(unaudited)

1. Description of the Business

2U, Inc. (the Company) was incorporated as 2Tor Inc. in the State of Delaware in April 2008 and changed its name to 2U, Inc. on October 11, 2012. Under long-term agreements, the Company provides a proprietary, cloud-based technology platform, bundled with technology-enabled services, that allows leading colleges and universities to deliver high quality online degree programs, extending the universities reach and distinguishing their brands. The Company s comprehensive learning platform acts as the hub for all student and faculty academic and social interaction. The Company also provides a suite of technology-enabled services that support the complete lifecycle of a higher education program or course, including attracting students, facilitating in-program field placements and providing technical support.

2. Summary of Significant Accounting Policies

Principles of Consolidation

The accompanying unaudited condensed consolidated financial statements include the accounts of the Company and its wholly-owned subsidiary. All intercompany accounts and transactions have been eliminated in consolidation.

Unaudited Condensed Consolidated Financial Information

The accompanying unaudited condensed consolidated financial statements and footnotes have been prepared in accordance with generally accepted accounting principles in the United States of America (U.S. GAAP). The Company has condensed or omitted certain information and footnote disclosures normally included in financial statements presented in accordance with U.S. GAAP in the accompanying unaudited condensed consolidated financial statements. In the opinion of management, the interim financial information includes all adjustments of a normal recurring nature necessary for a fair presentation of financial position, the results of operations, changes in stockholders equity (deficit) and cash flows, and the disclosures made herein are adequate to prevent the information presented from being misleading. The results of operations for the three and six months ended June 30, 2014 are not necessarily indicative of the results for the full year ending December 31, 2014 or the results for any future periods. These unaudited condensed consolidated interim financial statements should be read in conjunction with the audited consolidated financial statements and related notes for the year ended December 31, 2013, which are included in the Company s prospectus (the Prospectus) filed pursuant to Rule 424(b) under the Securities and Exchange Act of 1933, as amended, with the Securities and Exchange Commission on March 28, 2014.

There have been no changes to our significant accounting policies described in the Prospectus that have had a material impact on our unaudited condensed consolidated financial statements and related notes.

Initial Public Offering

On April 2, 2014, the Company closed the initial public offering of its common stock (IPO) in which the Company issued and sold 8,626,377 shares of its common stock, including the partial exercise of the underwriters over-allotment option, at an issuance price of $13.00 per share. The Company received net proceeds of $100.3 million after deducting underwriting discounts and commissions of $7.8 million and other offering expenses of approximately $4.0 million. Upon the closing of the IPO, all shares of the then-outstanding redeemable convertible preferred stock automatically converted into an aggregate of 23,501,208 shares of common stock, based on the shares of redeemable convertible preferred stock outstanding as of April 2, 2014. In addition, the outstanding Series D warrants automatically converted into warrants to purchase common stock, and the preferred stock warrant liability of $0.8 million as of April 2, 2014 was reclassified to additional paid-in capital.

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Use of Estimates

The preparation of financial statements in accordance with U.S. GAAP requires management to make certain estimates and assumptions that affect the amounts reported in the unaudited condensed consolidated financial statements and accompanying notes. On an ongoing basis, the Company evaluates its estimates, including those related to the useful lives of long-lived assets, fair value measurement and income taxes, among others. The Company bases its estimates on historical experience and on various other assumptions that it believes to be reasonable, the results of which form the basis for making judgments about the carrying value of assets and liabilities. Actual results could differ from those estimates.

Cash and Cash Equivalents

Cash and cash equivalents consist of bank checking and money market accounts and investments in certificates of deposit that mature in less than three months. The Company considers all highly liquid marketable securities with maturities at the time of purchase of three months or less to be cash equivalents, and they are carried at fair value.

Revenue Recognition and Deferred Revenue

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

The Company derives revenue under long-term contracts that typically range from 10 to 15 years in length. Under these contracts, the Company enables access to its cloud-based technology platform and provides technology-enabled marketing, content development and supporting services to its clients and their faculty and students. The Company is entitled to a contractually specified percentage of net program proceeds from its clients. These net program proceeds represent gross proceeds billed by clients to students, less credit card fees and other specified charges the Company has agreed to exclude in certain of its client contracts. A refund allowance is established for the Company s share of tuition and fees ultimately uncollected by its clients. The Company also offered rebates to a group of students who enrolled in a specific client program between 2009 and 2011, which the Company will pay to the student if he or she completes the degree and certain post-graduation work requirements within a specified period of time. These rebates and refunds offset the net program proceeds recognized as revenue. Revenue is recognized ratably over the service period, which the Company defines as the first through the last day of classes for each term in a client s program. The Company invoices its clients based on enrollment reports that are generated by its clients. In some instances, these enrollment reports are received prior to the conclusion of the drop/add period. In such cases, the Company establishes a reserve against revenue, if necessary, based on its estimate of changes in enrollments expected prior to the end of the drop/add period.

The Company generates revenue from multiple-deliverable contractual arrangements with its clients. Under each of these arrangements, the Company provides (i) a cloud-based technology platform that serves as a learning platform for its client s faculty and students and which also enables a comprehensive range of other client functions, (ii) program marketing and application services for student acquisition, (iii) in conjunction with the client s faculty members, content development for courses and (iv) faculty and student support services, including technical field training and support, non-academic student advising, academic progress monitoring and career services.

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

Advance payments are recorded as deferred revenue until services are delivered or obligations are met, at which time revenue is recognized. Deferred revenue as of a particular balance sheet date represents the excess of amounts received as compared to amounts recognized in revenue in the unaudited condensed consolidated

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statements of operations as of the end of the reporting period, and such amounts are reflected as a current liability on the Company s unaudited condensed consolidated balance sheets.

Fair Value Measurements

The carrying amounts of certain assets and liabilities, including cash and cash equivalents, accounts receivable, accounts payable and accrued expenses and other current liabilities, approximate their respective fair values due to their short-term nature.

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date, based on the Company s principal or, in the absence of a principal, most advantageous, market for the specific asset or liability.

U.S. GAAP provides for a three-tier fair value hierarchy to classify and disclose all assets and liabilities measured at fair value on a recurring basis, as well as assets and liabilities measured at fair value on a non-recurring basis, in periods subsequent to their initial measurement. The fair value hierarchy requires the Company to use observable inputs when available, and to minimize the use of unobservable inputs when determining fair value. The three tiers are defined as follows:

- *Level 1* Observable inputs that reflect quoted market prices (unadjusted) for identical assets or liabilities in active markets;
- *Level 2* Observable inputs, other than quoted prices in active markets, that are observable either directly or indirectly in the marketplace for identical or similar assets and liabilities; and
- *Level 3* Unobservable inputs that are supported by little or no market data, which require the Company to develop its own assumptions about the assumptions market participants would use in pricing the asset or liability based on the best information available in the circumstances.

Assets and Liabilities Measured at Fair Value on a Recurring Basis

The Company evaluates its financial assets and liabilities subject to fair value measurements on a recurring basis to determine the appropriate level in which to classify them for each reporting period. This determination requires significant judgments to be made.

Prior to converting to common stock warrants upon the closing of the IPO on April 2, 2014, the Company used an option pricing model to determine the fair value of the Series D redeemable convertible preferred stock warrants. The valuation required the input of subjective assumptions, including the risk-free interest rate, the value of the underlying securities and the expected stock price volatility. The risk-free interest rate assumption was based upon observed interest rates for constant maturity U.S. Treasury securities consistent with the term of the warrants. The expected stock price volatility assumption was based on historical volatilities for publicly traded stock of comparable companies over the term of the warrants. The value of the underlying securities assumption was based upon the market price of the Company s common stock as the redeemable convertible preferred stock warrants became convertible into shares of common stock upon closing of the IPO.

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 evaluates the creditworthiness of its clients and maintains an allowance for doubtful accounts, if needed.

The Company has two contracts with the same university that accounted for an aggregate of 68% and 54% of its revenue for the three months ended June 30, 2013 and 2014, respectively, and an aggregate of 71% and 58% of its revenue for the six months ended June 30, 2013 and 2014, respectively. Additionally, the Company has a contract with another university that accounted for approximately 18% and 16% of its revenue for the three months

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ended June 30, 2013 and 2014, respectively, and an aggregate of 17% and 16% of its revenue for the six months ended June 30, 2013 and 2014, respectively.

An aggregate of 51% and 32% of the Company s accounts receivable were from one university as of December 31, 2013 and June 30, 2014, respectively. Additionally, another university represented an aggregate of 3% and 31% of accounts receivable as of December 31, 2013 and June 30, 2014, respectively.

Property and Equipment

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

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

Capitalized Content Development Costs

The Company works with each client s faculty members to develop and maintain educational content that is delivered to their students through the Company s cloud-based technology platform. The online content developed jointly by the Company and its clients consists of subjects chosen and taught by clients faculty members and incorporates references and examples designed to remain relevant over extended periods of time. Online delivery of the content, combined with live, face-to-face instruction, provides the Company with rapid user feedback that it uses to make ongoing corrections, modifications and improvements to the course content. The Company s clients retain all intellectual property rights to the developed content, although the Company retains the rights to the content packaging and delivery mechanisms. Much of the Company s new content development uses proven delivery platforms and is therefore primarily subject-specific in nature. As a result, a significant portion of content development costs qualify for capitalization due to the focus of the Company s development efforts on the unique subject matter of the content. Similar to on-campus programs offered by the Company s clients, the online degree programs enabled by the Company offer numerous courses for each degree. The Company therefore capitalizes its development costs on a course-by-course basis. As students must matriculate into a client program in order to take a course, revenues and identifiable cash flows are also measured at the client program level.

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

The content development costs that qualify for capitalization are third-party direct costs, such as videography, editing and other services associated with creating digital content. Additionally, the Company

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capitalizes internal payroll and payroll-related costs incurred to create and produce videos and other digital content utilized in the clients programs for delivery via the Company s platform. Capitalization ends when content has been fully developed by both the Company and the client, at which time amortization of the capitalized content development costs begins. The capitalized costs are recorded on a class-by-class basis and included in capitalized content costs on the unaudited condensed consolidated balance sheets. These costs are amortized using the straight-line method over the estimated useful life of the respective capitalized content program, which is generally five years. The estimated useful life corresponds with the Company s planned curriculum refresh rate. This refresh rate is consistent with expected curriculum refresh rates as cited by program faculty members for similar on-campus programs. In order to assess the recoverability of the capitalized content development costs, the costs are grouped by program, which is the lowest level of independent cash flows. It is reasonably possible that the capitalized content development costs and internally developed software could become obsolete before the estimated useful lives are complete.

Impairment of Long-Lived Assets

The Company reviews long-lived assets, which consist of property and equipment and capitalized content costs, for impairment whenever events or changes in circumstances indicate the carrying value of an asset may not be recoverable. Recoverability of the long-lived asset is measured by a comparison of the carrying value of the asset or asset group to the future undiscounted net cash flows expected to be generated by the asset or asset group. If such assets are not recoverable, the impairment to be recognized is measured by the amount by which the carrying value of the asset exceeds the estimated fair value (discounted cash flow) of the asset or asset group. The Company s impairment analysis is based upon forecasted financial results. The actual results could vary from the Company s forecasts, especially in relation to recently launched programs.

Other Non-Current Assets

Other non-current assets consist primarily of deferred financing costs which were incurred by the Company directly in connection with obtaining its revolving line of credit. These deferred financing costs are amortized over a useful life equal to the term of the underlying line of credit. Additional other non-current assets consist of intangible assets associated with the Company s registered domain names and security deposits on leased office facilities. Until April 2, 2014, other non-current assets also consisted of costs the Company deferred which were incurred directly in connection with its IPO.

Refunds Payable

The Company records a refunds payable liability related to the amounts owed to clients as a result of students defaulting on their payments to clients. The Company may receive its portion of net program proceeds prior to a client collecting the full amount of tuition and applicable fees from its students. The Company calculates the refunds payable liability by estimating the future amounts owed to a client resulting from non-payment by students. The Company s estimate is based on historical collection experience, market and income trends, and a review of the client s accounts receivable aging.

Rebate Reserve

The Company has recorded a rebate reserve liability that results from having offered students who first enrolled in a specific Master of Arts in Teaching program between April 2009 and June 2011 a rebate if they complete their degree and teach in a designated low-income school district for five consecutive years within the first six years after graduation. The Company accounts for the rebate reserve as a contingent sales incentive and has recorded a rebate reserve liability to recognize the obligation to rebate amounts to students who satisfactorily complete the rebate requirements.

Advances to Clients

The Company sometimes advances payments to its clients in order to fund start-up expenses of the program on behalf of the client. Advances to clients are stated at realizable value. The advances are repaid to the Company on terms as required in the respective agreements. The Company recognizes imputed interest expense on these advance payments when there is a significant amount of imputed interest.

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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.

Stock-Based Compensation

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

Basic and Diluted Loss per Common Share

The Company uses the two-class method to compute net loss per common share because the Company has issued securities, other than common stock, that contractually entitle the holders to participate in dividends and earnings of the Company. The two-class method requires earnings for the period to be allocated between common stock and participating securities based upon their respective rights to receive distributed and undistributed earnings. Holders of each series of the Company s redeemable convertible preferred stock (prior to their conversion to common shares) were entitled to participate in distributions, when and if declared by the board of directors, that are made to common stockholders, and as a result are considered participating securities.

Under the two-class method, for periods with net income, basic net income per common share is computed by dividing the net income attributable to common stockholders by the weighted average number of shares of common stock outstanding during the period. Net income attributable to common stockholders is computed by subtracting from net income the portion of current year earnings that the participating securities would have been entitled to receive pursuant to their dividend rights had all of the year s earnings been distributed. No such adjustment to earnings is made during periods with a net loss, as the holders of the participating securities have no obligation to fund losses. Diluted net loss per common share is computed under the two-class method by using the weighted average number of shares of common stock outstanding, plus, for periods with net income attributable to common stockholders, the potential dilutive effects of stock options and warrants. In addition, the Company analyzes the potential dilutive effect of the outstanding participating securities under the if-converted method when calculating diluted earnings per share, in which it is assumed that the outstanding participating securities convert into common stock at the beginning of the period. The Company reports the more dilutive of the approaches (two-class or if-converted) as its diluted net income per share during the period. Due to net losses for the three- and six-month periods ended June 30, 2013 and 2014, basic and diluted loss per share were the same, as the effect of potentially dilutive securities would have been anti-dilutive.

Recent Accounting Pronouncements

In July 2013, the Financial Accounting Standards Board (FASB) issued ASU No. 2013-11, *Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists*, which is effective for interim or annual periods beginning after December 15, 2013. This guidance provides financial statement presentation guidance on whether an unrecognized tax benefit must be presented as either a reduction to a deferred tax asset or separately as a liability. The Company adopted this new guidance on January 1, 2014 and the adoption did not have a material impact on the Company s financial condition, results of operations or disclosures.

On May 28, 2014, the FASB issued ASU No. 2014-09, *Revenue from Contracts with Customers*, which requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. The ASU will replace most existing revenue recognition guidance in U.S. GAAP when it becomes effective. The new standard is effective for the Company on January 1, 2017. Early application is not permitted. The standard permits the use of either the retrospective or cumulative effect transition method. The Company is evaluating the effect that ASU 2014-09 will have on its consolidated financial statements and related

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disclosures. The Company has not yet selected a transition method nor has it determined the effect of the standard on its ongoing financial reporting.

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 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.

3. Fair Value Measurements

Assets and liabilities measured at fair value on a recurring basis are summarized below (in thousands):

	Balance as of December 31, 2013			
	Total	**Level 1**	**Level 2**	**Level 3**
Assets:				
Cash equivalents	$ 3,357	$ 3,357	$	$
Liabilities:				
Series D redeemable convertible preferred stock warrants	$ 126	$	$	$ 126

[redacted]

Assets:

[redacted]

In order to determine the fair value of the Series D redeemable convertible preferred stock warrants, the Company used an option pricing model. The valuation required the input of subjective assumptions, including the risk-free interest rate, the value of the underlying securities and the expected stock price volatility. The risk-free interest rate assumption was based upon observed interest rates for constant maturity U.S. Treasury securities consistent with the term of the warrants. The expected stock price volatility assumption was based on historical volatilities for publicly traded stock of comparable companies over the term of the warrants.

4. Property and Equipment

Property and equipment consisted of the following (in thousands):

	December 31, 2013	June 30, 2014
Internally-developed software	$ 5,516	$ 6,569
Computer hardware	2,082	2,254
Furniture and office equipment	774	1,067
Leasehold improvements	1,494	1,707
Total	9,866	11,597
Accumulated depreciation	(4,635)	(5,856)
Property and equipment, net	$ 5,231	$ 5,741

Depreciation expense for the three months ended June 30, 2013 and 2014 was $0.5 million and $0.6 million, respectively. Depreciation expense for the six months ended June 30, 2013 and 2014 was $0.9 million and $1.2 million, respectively.

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5. Capitalized Content Development Costs

Capitalized content development costs consisted of the following as of (in thousands):

	December 31, 2013	June 30, 2014
Capitalized content development costs	$ 11,816	$ 14,894
Capitalized content development costs in process	1,961	2,412
Accumulated amortization	(4,873)	(6,272)
Capitalized content development costs, net	$ 8,904	$ 11,034

The Company recorded amortization expense related to capitalized content development costs of $0.5 million and $0.7 million for the three months ended June 30, 2013 and 2014, respectively. The Company recorded amortization expense related to capitalized content development costs of $1.0 million and $1.4 million for the six months ended June 30, 2013 and 2014, respectively.

As of June 30, 2014, the estimated future amortization expense for the capitalized content development costs is as follows (in thousands):

2014	$ 1,450
2015	2,589
2016	2,117
2017	1,473
2018	903
Thereafter	90
Total	$ 8,622

6. Commitments and Contingencies

Line of Credit

On December 31, 2013, the Company secured a revolving line of credit for an aggregate borrowing base not to exceed $37.0 million. On January 21, 2014, the Company borrowed $5.0 million under this line of credit and repaid this borrowing in full on February 18, 2014; therefore, no amounts were outstanding as of June 30, 2014. The availability of this credit line is subject to the Company s compliance with certain reporting and financial covenants. The Company is currently in compliance with all such covenants.

Legal Contingencies

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

Program Marketing and Sales Commitments

When the Company enters into new agreements with its clients, the Company commits to meet certain staffing and spending investment thresholds related to program marketing and sales activities. The Company believes it is currently in compliance with all such commitments.

Operating Leases

The Company leases office facilities under non-cancelable operating leases in California, New York, Maryland, Missouri, North Carolina and Hong Kong. The Company also leases furniture and office equipment under non-cancelable leases. As of June 30, 2014, the future minimum lease payments (net of aggregate expected sublease payments of $0.5 million) were as follows (in thousands):

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2014	$	1,258
2015		2,384
2016		2,425
2017		1,922
2018		1,250
Thereafter		739
Total future minimum lease payments	$	9,978

The future minimum lease payments due under non-cancelable operating lease arrangements contain fixed rent increases over the term of the lease. Rent expense on these operating leases is recognized over the term of the lease on a straight-line basis. The excess of rent expense over future minimum lease payments due has been reported in other non-current liabilities in the accompanying unaudited condensed consolidated balance sheets. The deferred rent liability related to these leases totaled $0.5 million and $0.6 million as of December 31, 2013 and June 30, 2014, respectively.

Total net rent expense was $0.6 million for each of the three-month periods ended June 30, 2013 and 2014. Total net rent expense for the six-month periods ended June 30, 2013 and 2014 was $1.0 million and $1.3 million, respectively.

7. Income Taxes

Income taxes are accounted for under the asset and liability method, which requires the recognition of deferred tax assets and liabilities for the expected future tax consequences of events that are included in the financial statements. Deferred tax assets are subject to periodic recoverability assessments. Recognition of deferred tax assets is appropriate only if the likelihood of realization of such assets is more likely to occur, than not. At December 31, 2013, the Company had federal net operating loss (NOL) carryforwards of approximately $86.0 million, which expire between 2029 and 2033. At December 31, 2013, the Company had individual state net operating loss carryforwards up to $73.1 million, which expire between 2021 and 2033. For financial reporting purposes, a full valuation allowance has been established to offset the net deferred tax assets. The utilization of the loss carryforwards to reduce future income taxes will depend on the Company s ability to generate sufficient taxable income prior to the expiration of the NOL carryforwards. In addition, a certain portion of the above NOLs may be subject to Internal Revenue Code Section 382 limitations, which may limit their future use. The Company has experienced a number of transactions which could lead to a limitation of its NOLs under Section 382 of the Internal Revenue Code. The Company intends to complete a study regarding this limitation in the next nine months. It is reasonably possible that the results of the study will reduce the reported net operating losses and other deferred tax assets.

The Company determines its annual effective tax rate for the full fiscal year and applies that rate to its income before income taxes in determining its provision for income taxes for interim periods. The Company also records discrete items in each respective period as appropriate. The Company s effective tax rate for the three and six months ended June 30, 2013 and 2014 was 0%.

The Company permanently reinvests cumulative undistributed earnings of its subsidiary in non-U.S. operations. U.S. federal income taxes have not been provided for in relation to undistributed earnings to the extent that they are permanently reinvested in the Company s non-U.S. operations. It is not practical at this time to determine the income tax liability that would result upon repatriation to the United States. As of December 31, 2013 and June 30, 2014, the undistributed earnings of the Company s subsidiary were not material.

The Company applies the provisions of ASC 740-10 to uncertain tax positions. ASC 740-10 clarifies accounting for income taxes by prescribing a minimum probability threshold that a tax position must meet before a financial statement benefit is recognized. If the probability for sustaining a tax position is greater than 50%, then the tax position is warranted and recognition should be at the highest amount which would be expected to be realized upon settlement. The Company did not identify any tax positions that would be required for inclusion in the

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financial statements. As of June 30, 2014, the Company had not made any changes to its tax positions since December 31, 2013.

The Company recognizes interest and penalties related to uncertain tax positions in income tax expense. As of December 31, 2013 and June 30, 2014, the Company had no accrued interest or penalties related to uncertain tax positions.

The Company has analyzed its filing positions in all significant federal, state and foreign jurisdictions where it is required to file income tax returns, as well as open tax years in these jurisdictions. With few exceptions, the Company is no longer subject to U.S. federal, state and local tax examinations by tax authorities for the years prior to 2010, though the NOL carryforwards can be adjusted upon audit and could impact taxes owed in open tax years. No income tax returns are currently under examination by the taxing authorities.

8. Redeemable Convertible Preferred Stock

The following table summarizes the Company s issuances of redeemable convertible preferred stock:

Issue Date	Series	Purchase Price per Share	Number of Shares	Conversion Price per Share
June 2009	Series A	$ 1.27	10,033,976	$ 1.27
February 2010	Series B	$ 4.46	5,057,901	$ 4.46
March 2011	Series C	$ 7.34	4,429,601	$ 7.34
March 2012	Series D	$ 7.81	3,339,902	$ 7.81
January 2013	Series D	$ 7.81	639,828	$ 7.81

Each of the purchase prices per share above excludes the cost of issuance. Any costs incurred in connection with the issuance of the various classes of preferred stock have been recorded as a reduction of the carrying amount of the preferred stock and were accreted through a charge to additional paid-in capital through April 2, 2014.

Summary of Activity

The following table presents a summary of activity for the redeemable convertible preferred stock issued and outstanding for the periods presented below (in thousands):

	Redeemable Convertible Preferred Stock				
	Series A	Series B	Series C	Series D	Total Amount

Balance, December 31, 2013	$	12,384	$	22,210	$	32,405	$	31,048	$	98,047
Accretion of issuance costs on redeemable convertible preferred stock		36		36		12		5		89
Conversion of preferred stock into common stock		(12,420)		(22,246)		(32,417)		(31,053)		(98,136)
Balance, June 30, 2014	$		$		$		$		$	

Upon closing of the Company s IPO on April 2, 2014, all outstanding shares of redeemable convertible preferred stock automatically converted into an aggregate of 23,501,208 shares of common stock.

9. Common Stock and Preferred Stock Reserved for Future Issuance

Immediately upon the closing of the IPO on April 2, 2014, the Company s certificate of incorporation was amended and restated to, among other things, authorize 200,000,000 shares of common stock and 5,000,000 shares of preferred stock. As of June 30, 2014, 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, 2014, the Company had reserved a total of 8,278,545 of its authorized shares of common stock for future issuance as follows:

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Outstanding stock options	6,388,908
Possible future issuance under stock option plans	888,247
Outstanding restricted stock units	1,001,390
Total common shares reserved for future issuance	8,278,545

10. Warrants

In connection with the line of credit secured in April 2012, the Company issued a warrant to purchase 12,797 shares of the Company s Series D redeemable convertible preferred stock with an exercise price of $7.81 per share and an expiration date in 2022. The warrant was valued at $74 thousand on the date of grant and at $19 thousand as of December 31, 2013.

In connection with the line of credit secured in December 2013, the Company issued a warrant to purchase 71,021 shares of the Company s Series D redeemable convertible preferred stock with an exercise price of $7.81 per share and an expiration date in 2023. The warrant was valued at $107 thousand as of December 31, 2013.

As of December 31, 2013, each of the Series D warrants were classified as a liability in the accompanying unaudited condensed consolidated balance sheets and adjusted to fair value due to the fact that they were exercisable into redeemable convertible preferred securities.

Upon the closing of the Company s IPO on April 2, 2014, the warrants to purchase Series D redeemable convertible preferred stock automatically converted into warrants to purchase common stock and the liability at its then fair value of $821 thousand was reclassified to additional paid-in capital. Prior to April 2, 2014, the inputs to the fair value model for the warrants were considered Level 3 inputs under ASC 820, *Fair Value Measurements and Disclosures*, and all changes in the fair value of the warrants were recorded as a component of interest expense. The Company recorded reductions of interest expense of $5 thousand and $13 thousand for the three and six months ended June 30, 2013, respectively, related to the fair value adjustment of the warrants. The Company recorded interest expense of $7 thousand and $695 thousand for the three and six months ended June 30, 2014, respectively, related to the fair value adjustment of the warrants, which represents a non-cash financing activity for purposes of the condensed consolidated statement of cash flows.

On May 22, 2014, the holder of the warrants issued a notice of exercise to the Company to purchase 83,818 shares of common stock. In lieu of payment of the exercise price, the Company withheld from issuance a number of shares equal to the full exercise price divided by the price per share of the Company s common stock as measured on a volume weighted average price basis over the 10-day trading period immediately prior to May 22, 2014. Consequently, the exercise of the warrants resulted in the issuance of 32,709 shares of the Company s common stock to the holder of the warrants, which represents a non-cash financing activity for purposes of the condensed consolidated statement of cash flows.

11. Stock-Based Compensation

The Company maintains two share-based employee compensation plans: the 2008 Stock Incentive Plan (the 2008 Plan) and the 2014 Equity Incentive Plan (the 2014 Plan). The 2008 Plan provided for the grant of incentive stock options to the Company s employees, and for the grant of nonstatutory stock options, restricted stock awards and deferred stock awards to the Company s employees, directors and consultants.The 2014 Plan provides for the grant of incentive stock options to the Company s employees, and for the grant of nonstatutory stock options, restricted stock awards, restricted stock unit awards, stock appreciation rights, performance stock awards and other forms of stock compensation to the Company s employees, including officers, consultants and directors. The 2014 Plan also provides for the grant of performance cash awards to the Company s employees, consultants and directors. Shares reserved but unissued under the 2008 Plan are included as shares to be reserved for issuance under the 2014 Plan. No further options or stock awards can be granted under the 2008 Plan, and all outstanding stock awards granted under the 2008 Plan will continue to be governed by their existing terms.

The Company s stock-based compensation expense included in the unaudited condensed consolidated statements of operations is as follows:

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	Three Months Ended June 30, 2013	Three Months Ended June 30, 2014	Six Months Ended June 30, 2013	Six Months Ended June 30, 2014
	(in thousands)			
Servicing and support	$ 101	$ 401	$ 193	$ 614
Technology and content development	40	226	63	309
Program marketing and sales	52	218	90	321
General and administrative	439	1,199	722	1,995
Total stock-based compensation expense	$ 632	$ 2,044	$ 1,068	$ 3,239

A total of 2,800,000 shares of the Company s common stock are reserved for issuance pursuant to the 2014 Plan. In addition, the shares to be reserved for issuance under the 2014 Plan will include (a) those shares reserved but unissued under the 2008 Plan, and (b) shares returned to the 2008 Plan as the result of expiration or termination of awards (provided that the maximum number of shares that may be added to the 2014 Plan pursuant to (a) and (b) is 5,943,348 shares). The number of shares of the Company s common stock that may be issued under the 2014 Plan will automatically increase on January 1 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 following is a summary of the option activity:

	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, 2013	5,883,885	$ 3.53	7.45	$ 36,884
Granted	1,284,191	11.12	9.31	
Exercised	(464,803)	2.20	5.68	
Forfeited	(314,365)	2.94		
Expired				
Outstanding balance at June 30, 2014	6,388,908	5.18	7.66	74,288
Exercisable at June 30, 2014	3,070,133	2.47	6.38	44,031
Vested and expected to vest at June 30, 2014	6,084,304	5.02	7.59	71,731

Total compensation cost related to the nonvested awards not yet recognized as of June 30, 2014 was $14.2 million and will be recognized over a weighted average period of approximately 2.7 years.

The aggregate intrinsic value of the employee options exercised during the six months ended June 30, 2014 was $6.8 million.

12. Net Loss per Share

Diluted loss per share is the same as basic 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 common shares outstanding because the effect is anti-dilutive:

	Three and Six Months Ended June 30,	
	2013	**2014**
Redeemable convertible preferred stock:		
Series A	10,033,976	
Series B	5,057,901	
Series C	4,429,601	
Series D	3,979,730	
Warrants to purchase Series D redeemable convertible preferred stock	12,797	
Stock options	5,604,989	6,388,908
Restricted stock units		1,001,390

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Basic and diluted net loss per share attributable to common stockholders is calculated as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	**2014**	**2013**	**2014**
Numerator (in thousands):				
Net loss attributable to common stockholders	$ (8,982)	$ (10,597)	$ (12,815)	$ (17,734)
Denominator:				
Weighted-average common shares outstanding, basic and diluted	7,398,059	39,304,884	7,392,129	23,588,330
Net loss per share attributable to common stockholders, basic and diluted	$ (1.21)	$ (0.27)	$ (1.73)	$ (0.75)

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

You should read the following discussion of our financial condition and results of operations in conjunction with the unaudited condensed consolidated financial statements and the notes thereto included elsewhere in this Quarterly Report on Form 10-Q and with our audited consolidated financial statements included in our prospectus filed pursuant to Rule 424(b) under the Securities Act of 1933, as amended, with the Securities and Exchange Commission on March 28, 2014 (Prospectus).

Overview

We are a leading provider of cloud-based SaaS solutions that enable leading nonprofit colleges and universities to deliver their high quality education to qualified students anywhere. Our innovative online learning platform and bundled technology-enabled services provide the comprehensive operating infrastructure colleges and universities need to attract, enroll, educate, support and graduate their students. By leveraging our solutions, we believe our clients are able to expand their addressable markets while providing educational engagement, experiences and outcomes to their online students that match or exceed those of their on-campus offerings.

Our clients are leading nonprofit colleges and universities. They use our platform to offer full undergraduate, graduate and doctoral degree programs online. The students in these programs receive the same degree or credit as their on-campus counterparts, where one exists, and generally pay equivalent tuition. We provide a suite of technology-enabled services designed to promote adoption and usage of our SaaS solutions by clients and enrollment and retention of their students. These services include program marketing, student acquisition, content development for courses, and faculty and student support services, including technical training and support, non-academic student advising, academic progress monitoring and career services. We also facilitate in-program field placements, student immersions and other student enrichment experiences.

We are currently engaged by eight well-recognized colleges and universities to enable 12 graduate programs that have launched and in which students have enrolled. The first of our clients programs was launched in 2009. One additional program launched in 2010 with two more commencing in 2011. In 2013, our clients launched five new programs. An additional three programs launched in 2014 and one additional program with an existing client is scheduled to commence later in 2014. A dual degree between an additional university client and one of our existing clients is also scheduled to launch later in 2014, and we have contracted with three additional universities to enable four new graduate programs that we expect to launch in 2015. Our client contracts generally have initial terms between 10 and 15 years in length, and, since our inception, all of the clients that have engaged us remain active.

A significant percentage of our annual revenue is related to students returning to our clients programs after their first semester. In the six month period ended June 30, 2014, 89% of our revenue was related to students who had enrolled and completed their first semester prior to the start of the quarter. We believe this high percentage of revenue attributable to returning students contributes to the predictability and recurring nature of our business.

We believe our business strategy will continue to offer significant opportunities for growth, but it also presents a number of risks and challenges. In particular, to remain competitive, we will need to continue to innovate in a rapidly changing landscape for the application of technology like ours to the delivery of higher education. As described above, we have added, and we intend to continue to add, degree programs in a number of new academic disciplines each year, as well as to expand the delivery of existing degree programs to new clients. To do so, we will need to convince new clients as to the quality and value of our SaaS solutions, cost-effectively identify qualified students for our clients programs and help our clients retain those students once enrolled. We must also be able to successfully execute our business strategy while navigating constantly changing higher education laws and regulations applicable to our clients and, in some cases to ourselves, particularly the incentive compensation rule that prohibits making incentive payments related to student acquisition. We seek to ensure that addressing all of these risks and challenges does not divert our management s attention from continuing to build on the strengths that we believe have driven the growth of our business over the last several years. We believe our focus on delivering a differentiated technology platform, maintaining the integrity of our clients educational brands and providing

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exceptional, white glove service to our clients will contribute to the success of our business. We cannot, however, assure you that we will be successful in addressing and managing the many challenges and risks that we face.

Our Business Model

The key elements of our business model are described below.

Revenue Drivers

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 to enroll in their programs. Accordingly, the primary driver of our revenue growth is the number of student course enrollments in our clients programs. This in turn is influenced primarily by three factors:

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

In the near term, we expect the primary drivers of our financial results to continue to be our two programs with the University of Southern California, which are our longest running programs, launched in 2009 and 2010. For the three months ended June 30, 2013 and 2014, 68% and 54%, respectively, of our revenue was derived from these two programs. For the six months ended June 30, 2013 and 2014, 71% and 58%, respectively, of our revenue was derived from these two programs. We expect the University of Southern California will continue to account for a large portion of our revenue until our other client programs become more mature and achieve significantly higher enrollment levels.

Additionally, the Company has a contract with another university that accounted for approximately 18% and 16% of its revenue for the three months ended June 30, 2013 and 2014, respectively, and 17% and 16% of its revenue for the six months ended June 30, 2013 and 2014, respectively.

Program Marketing and Sales Expense

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

We have primary responsibility for identifying qualified students for our clients programs, generating potential student interest in the programs and driving applications to the programs. While our clients make all admissions decisions, the number of students who enroll in our clients programs in any given period is significantly dependent on the amount we have spent on these student acquisition activities in prior periods. Accordingly, although most of our clients programs span multiple semesters and, therefore, generate continued revenue beyond the term in which initial enrollments occurs, 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 lead acquisition to initial enrollment was seven months. For the students who have graduated from these programs, the average time from initial enrollment to graduation was 16 months. However, because our clients programs are relatively new, they have only graduated a limited number of students to date, with many early enrollees still enrolled. Based on the student retention rates and patterns we have observed in

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our clients programs, we estimate that, for our current programs, the average time from a student s initial enrollment to graduation will be approximately 2.5 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 student acquisition activities in earlier periods. Because program marketing and sales expense in any period are almost entirely unrelated to revenue generated in that period, we do not believe it is meaningful to directly compare the two. We believe that the total revenue we will receive in the future from students who enroll in our clients programs as a result of current period program marketing and sales expense will be significantly greater as a multiple of that expense than is implied by the multiple of current period revenue to current period program marketing and sales expense. Further, we believe that our program marketing and sales expense in future periods will generally decline as a percentage of the revenue reported in those same periods as our revenue base from returning students in existing programs becomes larger.

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.

The semesters of our clients programs often 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 semester, and once the drop/add period has passed. We recognize the related revenue ratably over the course of the semester. 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 technology and content development, 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.

Key Business and Financial Performance Metrics

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

Platform Revenue Retention Rate

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

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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 correlation between the platform revenue retention rate and the number of programs included in the calculation of that rate. The number of programs may increase while the retention rate declines.

	Three Months Ended June 30,		**Six Months Ended June 30,**	
	2013	**2014**	**2013**	**2014**
Platform revenue retention rate	138.2%	113.5%	141.8%	117.3%
Number of programs included in comparison (1)	4	6	4	4

(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. These additional programs will typically have lower tuition costs than the initial program in that discipline. 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, 2013	Three Months Ended June 30, 2014	Six Months Ended June 30, 2013	Six Months Ended June 30, 2014
Full course equivalent enrollments in our clients program	6,950	9,331	14,600	19,140
Average revenue per full course equivalent enrollment in our clients programs	$ 2,689	$ 2,652	$ 2,591	$ 2,669

Adjusted EBITDA

Adjusted EBITDA represents our earnings before net interest (income) expense, income taxes, depreciation and amortization, adjusted to eliminate stock-based compensation expense, which is a non-cash item. Adjusted EBITDA is a key measure used by our management and board of directors to understand and evaluate our core

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

- although depreciation and amortization are non-cash charges, the assets being depreciated and amortized may have to be replaced in the future, and adjusted EBITDA does not reflect cash capital expenditure requirements for such replacements or for new capital expenditure requirements;
- adjusted EBITDA does not reflect changes in, or cash requirements for, our working capital needs;
- adjusted EBITDA does not reflect the potentially dilutive impact of equity-based compensation;
- adjusted EBITDA does not reflect interest or tax payments that may represent a reduction in cash available to us; and
- other companies, including companies in our industry, may calculate adjusted EBITDA differently, which reduces its usefulness as a comparative measure.

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

	Three Months Ended June 30,		**Six Months Ended June 30,**	
	2013	**2014**	**2013**	**2014**
	(in thousands)			
Net loss	$ (8,895)	$ (10,595)	$ (12,641)	$ (17,645)
Adjustments:				
Interest expense	(5)	134	(13)	918
Interest income	(10)	(31)	(16)	(32)
Depreciation and amortization expense	1,016	1,363	1,942	2,646
Stock-based compensation expense	632	2,044	1,068	3,239

Total adjustments		1,633		3,510		2,981		6,771
Adjusted EBITDA (loss)	$	(7,262)	$	(7,085)	$	(9,660)	$	(10,874)

Components of Operating Results

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. Our contracts generally 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 semester in a client s program.

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

We also offered rebates to a limited group of students who enrolled in a specific client program between 2009 and 2011, which we will be required to pay to such students if they complete their degrees and pre-specified,

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post-graduation work requirements within a defined period of time after graduation. For students in this group who are still enrolled in the program, we accrue the rebate liability as they continue through the program towards graduation. In addition, all students in this group are required to certify to us each September as to their continuing eligibility for these rebates. For those students who do not make such certification and are therefore no longer eligible for the rebate, because, for example, they have failed to meet their post-graduation work requirements, we reduce the allowance accordingly at that time. As of December 31, 2013 and June 30, 2014, 323 and 316 students, respectively, remained eligible to receive these rebates. These rebates and refunds offset the net program proceeds that we recognize as revenue.

The following table details the components of our revenue for the periods indicated.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2014	2013	2014
	(in thousands)			
Net program proceeds	$ 18,907	$ 24,960	$ 38,169	$ 51,495
Rebates	(24)	8	(44)	5
Refunds	(219)	(225)	(354)	(434)
Other	27	1	54	10
Revenue	$ 18,691	$ 24,744	$ 37,825	$ 51,076

In addition to providing access to our cloud-based technology platform, we provide bundled technology-enabled services, including program marketing services for student acquisition, content development services, faculty and student support services, including technical training and support, non-academic student advising, academic progress monitoring and career services. We also facilitate in-program field placements, student immersions and other student enrichment experiences. We have determined that no individual deliverable has standalone value upon delivery and, therefore, the multiple deliverables within our arrangements do not qualify for treatment as separate units of accounting. Accordingly, we consider all deliverables to be a single unit of accounting and we recognize revenue from the entire arrangement over the term of the service period.

We generally receive payments from our clients early in each semester, 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 unaudited condensed consolidated statements of operations as of that date.

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, increase our program promotion and student acquisition efforts, expand our technology infrastructure and increase our other program support capabilities. As a result, we expect our costs and expenses to increase in absolute dollars, but to decrease as a percentage of revenue over time as we achieve economies of scale through the expansion of our business.

Servicing and support. Servicing and support costs consist primarily of compensation costs related to program management and operations, as well as costs for platform technical support and faculty and student support. We also facilitate in-program field placements, student immersions and other student enrichment experiences, and we assist our clients with their state compliance requirements. It also includes software licensing, telecommunications and other costs to maintain platform access for our clients and their students.

Technology and content development. Technology and content development costs consist primarily of compensation and outsourced services costs related to the ongoing improvement and maintenance of our technology platform and content developed for our client programs, as well as costs to support our internal infrastructure, including our cloud-based server usage. It also includes the associated depreciation and amortization expense related to internally developed software and content, as well as hosting and other costs associated with maintaining our platform in a cloud environment.

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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 lead generation, as well as compensation costs for our program marketing, search engine optimization, marketing analytics and application counseling personnel. We expense all costs related to program marketing and sales as they are incurred.

General and administrative. General and administrative expense consists primarily of compensation costs for employees in our executive, administrative, finance and accounting, legal, strategy 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.

Other Income (Expense)

Other income (expense) consists of interest income and interest expense. 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 and convertible notes prior to their conversion and changes in our preferred stock warrant liability as a result of changes in the fair value of such warrants (through April 2, 2014).

The fair value of our preferred stock warrant liability was reassessed at the end of each reporting period and any increase in fair value was recognized in other expense, while any decrease in fair value was recognized in other income. Upon completion of our initial public offering, the preferred stock warrants automatically became warrants to purchase common stock. At that time, we reclassified the preferred stock warrant liability to additional paid-in capital and no further changes in fair value will be recognized in other income or expense.

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-month periods ended June 30, 2013 and 2014.

Critical Accounting Policies and Significant Judgments and Estimates

This management s discussion and analysis of financial condition and results of operations is based on our unaudited condensed consolidated financial statements, which have been prepared in accordance with U.S. GAAP. The preparation of these unaudited condensed consolidated financial statements requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the unaudited condensed consolidated financial statements, and the reported amounts of revenue and expenses during the reported period. In accordance with U.S. GAAP, we base our estimates on historical experience and on various other assumptions we believe to be reasonable under the circumstances. Actual results may differ from these estimates if conditions differ from our assumptions. Our significant accounting policies are described in Note 2 in Notes to Condensed Consolidated Financial Statements included in

Part I, Item 1 of this Quarterly Report on Form 10-Q. During the six months ended June 30, 2014, there were no material changes to our critical accounting policies and estimates, which are disclosed in our audited consolidated financial statements for the year ended December 31, 2013 included in our Prospectus.

Recent Accounting Pronouncements

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

On May 28, 2014, the FASB issued ASU No. 2014-09, *Revenue from Contracts with Customers*, which requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. The ASU will replace most existing revenue recognition guidance in U.S. GAAP when it becomes effective. The new standard is effective for the Company on January 1, 2017. Early application is not permitted. The standard permits the use of either the retrospective or cumulative effect transition method. The Company is evaluating the effect that ASU 2014-09 will have on its consolidated financial statements and related disclosures. The Company has not yet selected a transition method nor has it determined the effect of the standard on its ongoing financial reporting.

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Results of Operations

Comparison of Three Months Ended June 30, 2013 and 2014

The following table sets forth selected unaudited condensed consolidated statement of operations data for each of the periods indicated.

	Three Months Ended June 30,					
	2013		2014		Period-to-Period Change	
	Amount	Percentage of Revenue	Amount	Percentage of Revenue	Amount	Percentage
			(dollars in thousands)			
Revenue	$ 18,691	100.0%	$ 24,744	100.0%	$ 6,053	32.4%
Costs and expenses:						
Servicing and support	5,656	30.3	7,000	28.3	1,344	23.8
Technology and content development	4,596	24.6	5,818	23.5	1,222	26.6
Program marketing and sales	13,695	73.3	16,710	67.5	3,015	22.0
General and administrative	3,654	19.5	5,708	23.1	2,054	56.2
Total costs and expenses	27,601	147.7	35,236	142.4	7,635	27.7
Loss from operations	(8,910)	(47.7)	(10,492)	(42.4)	(1,582)	17.7
Other income (expense):						
Interest expense	5	0.0	(134)	(0.5)	(139)	(2,649.3)
Interest income	10	0.1	31	0.1	21	209.9
Total other income (expense)	15	0.1	(103)	(0.4)	(118)	(781.6)
Net loss	$ (8,895)	(47.6)%	$ (10,595)	(42.8)%	$ (1,700)	19.1

Revenue. Revenue increased by $6.0 million, or 32.4%, from $18.7 million for the three months ended June 30, 2013 to $24.7 million for the three months ended June 30, 2014. Of the increase, $2.2 million was primarily attributable to increased period-over-period full course equivalent enrollments in the four client programs launched prior to January 1, 2013. Full course equivalent enrollments in the new client programs that launched after January 1, 2013 resulted in additional revenues of $3.8 million.

Servicing and support. Servicing and support costs increased by $1.3 million, or 23.8%, from $5.7 million for the three months ended June 30, 2013 to $7.0 million for the same period of 2014. This increase was due primarily to a $0.8 million increase in compensation costs and a $0.2 million increase in travel expenses as we increased our headcount in this area by 28% to serve a growing number of students and faculty in existing and new client programs. The remaining increase of $0.3 million was primarily attributable to increased costs for facilitating in-program field placements and student support services. As a percentage of revenue, servicing and support costs decreased from 30.3% for the three months ended June 30, 2013 to 28.3% for the same period of 2014, as client programs continued to mature and greater operational efficiencies were achieved.

Technology and content development. Technology and content development costs increased by $1.2 million, or 26.6%, from $4.6 million for the three months ended June 30, 2013 to $5.8 million for the same period of 2014. This was due primarily to a $0.6 million increase in compensation costs, net of capitalized amounts for software and content development, as we increased our headcount in this area by 30% to support additional client program launches and scaling of existing client programs. Further, an increase of $0.3 million resulted from higher depreciation expense associated with our capitalized internal use software and content development costs, primarily as a result of an increase in the number of courses that have been developed for our client programs. The remaining increase of $0.3 million was attributable to increased costs for telecommunication, travel and other expenses. As a percentage of revenue, technology and content development costs decreased from 24.6% for the three months ended June 30, 2013 to 23.5% for the same period of 2014, due primarily to our increased revenue.

Program marketing and sales. Program marketing and sales expense increased by $3.0 million, or 22.0%, from $13.7 million for the three months ended June 30, 2013 to $16.7 million for the same period of 2014. This increase was due primarily to a $1.7 million increase in compensation costs and a $0.5 million increase in travel expenses, as we increased our headcount in this

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area by 39% to acquire students for, and drive revenue growth in, new client programs. Additionally, lead generation costs increased by a total of $1.0 million, while other general program marketing and sales expenses, including advertising research, printing, public relations and advertisement hosting fees, decreased by a total of $0.2 million, as we achieved efficiencies in our program marketing efforts to acquire students for our clients programs. As a percentage of revenue, program marketing and sales expense decreased from 73.3% for three months ended June 30, 2013 to 67.5% for the same period of 2014, reflecting a higher year-over-year percentage increase in revenue than the corresponding increase in program marketing and sales expense.

General and administrative. General and administrative expense increased by $2.0 million, or 56.2%, from $3.7 million for the three months ended June 30, 2013 to $5.7 million for the same period of 2014. Increased wages and payroll taxes of $0.6 million, and increased bonus expense of $0.2 million, were driven primarily by a 30% increase in general and administrative headcount as we prepared for our initial public offering and to operate as a public company. Stock option expense increased by $0.8 million due to additional equity grants and the increased value of our common shares. Further, legal, accounting and other professional fees increased by $0.3 million, also in preparation to operate as a public company, and travel and other general and administrative expense increased by $0.1 million, driven by the increase in headcount. As a percentage of revenue, general and administrative expense increased from 19.5% for the three months ended June 30, 2013 to 23.1% compared to the same period of 2014.

Comparison of Six Months Ended June 30, 2013 and 2014

The following table sets forth selected unaudited condensed consolidated statements of operations data for each of the periods indicated.

	Six Months Ended June 30, 2013		2014		Period-to-Period Change	
	Amount	Percentage of Revenue	Amount	Percentage of Revenue	Amount	Percentage
	(dollars in thousands)					
Revenue	$ 37,825	100.0%	$ 51,076	100.0%	$ 13,251	35.0%
Costs and expenses:						
Servicing and support	10,674	28.2	13,248	25.9	2,574	24.1
Technology and content development	7,831	20.7	11,492	22.5	3,661	46.8
Program marketing and sales	25,465	67.3	31,951	62.6	6,486	25.5
General and administrative	6,525	17.3	11,144	21.8	4,619	70.8
Total costs and expenses	50,495	133.5				