

2U, Inc.
Form 10-Q
November 05, 2018

Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q
(Mark One)

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

For the quarterly period ended September 30, 2018

or

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

For the transition period from to

Commission File Number: 001-36376

2U, INC.

(Exact name of registrant as specified in its charter)

Delaware

26-2335939

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

7900 Harkins Road,

20706

Lanham, MD

(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 Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted 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 such files). Yes No

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

Large accelerated filer Accelerated filer

Non-accelerated filer Smaller reporting company

Emerging growth company

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No

As of October 31, 2018, there were 57,922,612 shares of the registrant's common stock, par value \$0.001 per share, outstanding.

Table of Contents

TABLE OF CONTENTS

<u>PART I. FINANCIAL INFORMATION</u>	<u>4</u>
<u>Item 1. Financial Statements</u>	<u>4</u>
Condensed Consolidated Balance Sheets as of September 30, 2018 (unaudited) and December 31, 2017	<u>4</u>
Condensed Consolidated Statements of Operations and Comprehensive Loss (unaudited) for the three and nine months ended September 30, 2018 and 2017	<u>5</u>
Condensed Consolidated Statements of Changes in Stockholders' Equity (unaudited) for the three and nine months ended September 30, 2018	<u>6</u>
Condensed Consolidated Statements of Cash Flows (unaudited) for the nine months ended September 30, 2018 and 2017	<u>7</u>
<u>Notes to Condensed Consolidated Financial Statements (unaudited)</u>	<u>8</u>
<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	<u>22</u>
<u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u>	<u>38</u>
<u>Item 4. Controls and Procedures</u>	<u>38</u>
<u>PART II. OTHER INFORMATION</u>	<u>39</u>
<u>Item 1. Legal Proceedings</u>	<u>39</u>
<u>Item 1A. Risk Factors</u>	<u>39</u>
<u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>	<u>39</u>
<u>Item 3. Defaults Upon Senior Securities</u>	<u>39</u>
<u>Item 4. Mine Safety Disclosures</u>	<u>39</u>
<u>Item 5. Other Information</u>	<u>39</u>
<u>Item 6. Exhibits</u>	<u>40</u>
<u>Signatures</u>	<u>41</u>

Table of Contents

SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

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

Forward-looking statements include statements about:

- trends in the higher education market and the market for online education, and expectations for growth in those markets;
- the acceptance, adoption and growth of online learning by colleges and universities, faculty, students, employers, accreditors and state and federal licensing bodies;
- our ability to comply with evolving regulations and legal obligations related to data privacy, data protection and information security;
- our expectations about the potential benefits of our cloud-based software-as-a-service, or “SaaS,” technology and technology-enabled services to university clients and students;
- our dependence on third parties to provide certain technological services or components used in our platform;
- our ability to meet the anticipated launch dates of our graduate programs and short courses;
- our expectations about the predictability, visibility and recurring nature of our business model;
- our ability to acquire new university clients and expand our graduate programs and short courses with existing university clients;
- our ability to successfully integrate the operations of Get Educated International Proprietary Limited, or GetSmarter, achieve the expected benefits of the acquisition and manage, expand and grow the combined company;
- our ability to execute our growth strategy in the international, undergraduate and non-degree alternative markets;
- our ability to continue to acquire prospective students for our graduate programs and short courses;
- our ability to affect or increase student retention in our graduate programs;
- our expectations about the scalability of our cloud-based platform;
- our expectations regarding future expenses in relation to future revenue;
- potential changes in regulations applicable to us or our university clients; and
- our expectations regarding the amount of time our cash balances and other available financial resources will be sufficient to fund our operations.

Table of Contents

You should refer to the risks described in Part I, Item 1A “Risk Factors” in our Annual Report on Form 10-K for the year ended December 31, 2017 for a discussion of important factors that may cause our actual results to differ materially from those expressed or implied by our forward-looking statements. As a result of these factors, we cannot assure you that the forward-looking statements in this Quarterly Report on Form 10-Q will prove to be accurate. Furthermore, if our forward-looking statements prove to be inaccurate, the inaccuracy may be material. In light of the significant uncertainties in these forward-looking statements, you should not regard these statements as a representation or warranty by us or any other person that we will achieve our objectives and plans in any specified time frame, or at all. We undertake no obligation to publicly update any forward-looking statements, whether as a result of new information, future events or otherwise, except as required by law.

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

Table of Contents

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

2U, Inc.

Condensed Consolidated Balance Sheets

(in thousands, except share and per share amounts)

	September 30, 2018	December 31, 2017
	(unaudited)	
Assets		
Current assets		
Cash and cash equivalents	\$ 442,226	\$ 223,370
Short-term investments	25,000	—
Accounts receivable, net	49,651	14,174
Prepaid expenses and other assets	14,878	10,509
Total current assets	531,755	248,053
Property and equipment, net	51,527	49,055
Goodwill	62,955	71,988
Amortizable intangible assets, net	130,692	90,761
Prepaid expenses and other assets, non-current	34,562	22,205
Total assets	\$ 811,491	\$ 482,062
Liabilities and stockholders' equity		
Current liabilities		
Accounts payable and accrued expenses	\$ 34,513	\$ 22,629
Accrued compensation and related benefits	20,137	19,017
Deferred revenue	18,953	7,024
Other current liabilities	10,708	9,330
Total current liabilities	84,311	58,000
Deferred government grant obligations	3,500	3,500
Deferred tax liabilities, net	7,001	10,087
Lease-related and other liabilities, non-current	24,550	22,643
Total liabilities	119,362	94,230
Commitments and contingencies (Note 5)		
Stockholders' equity		
Preferred stock, \$0.001 par value, 5,000,000 shares authorized, none issued	—	—
Common stock, \$0.001 par value, 200,000,000 shares authorized, 57,905,339 shares issued and outstanding as of September 30, 2018; 52,505,856 shares issued and outstanding as of December 31, 2017	58	53
Additional paid-in capital	948,070	588,289
Accumulated deficit	(248,998)	(205,836)
Accumulated other comprehensive income (loss)	(7,001)	5,326
Total stockholders' equity	692,129	387,832
Total liabilities and stockholders' equity	\$ 811,491	\$ 482,062

See accompanying notes to condensed consolidated financial statements.

Table of Contents

2U, Inc.

Condensed Consolidated Statements of Operations and Comprehensive Loss
(unaudited, in thousands, except share and per share amounts)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
Revenue	\$ 106,963	\$ 70,250	\$ 296,674	\$ 200,074
Costs and expenses				
Curriculum and teaching	6,351	1,792	16,665	1,792
Servicing and support	16,586	12,939	49,116	37,322
Technology and content development	16,361	12,735	45,436	33,080
Marketing and sales	60,548	41,311	171,982	113,223
General and administrative	18,974	17,227	63,323	44,821
Total costs and expenses	118,820	86,004	346,522	230,238
Loss from operations	(11,857)	(15,754)	(49,848)	(30,164)
Interest income	1,799	18	3,053	267
Interest expense	(27)	(36)	(81)	(37)
Other income (expense), net	(273)	59	(1,493)	(972)
Loss before income taxes	(10,358)	(15,713)	(48,369)	(30,906)
Income tax benefit	414	974	5,207	974
Net loss	\$(9,944)	\$(14,739)	\$(43,162)	\$(29,932)
Net loss per share, basic and diluted	\$(0.17)	\$(0.30)	\$(0.78)	\$(0.62)
Weighted-average shares of common stock outstanding, basic and diluted	57,663,361	48,961,914	55,128,845	47,962,201
Other comprehensive loss				
Foreign currency translation adjustments, net of tax of \$0 for all periods presented	(2,781)	(3,617)	(12,327)	(3,617)
Comprehensive loss	\$(12,725)	\$(18,356)	\$(55,489)	\$(33,549)

See accompanying notes to condensed consolidated financial statements.

Table of Contents

2U, Inc.

Condensed Consolidated Statements of Changes in Stockholders' Equity
(unaudited, in thousands, except share amounts)

	Common Stock		Additional	Accumulated	Accumulated	Total
	Shares	Amount	Paid-In Capital	Deficit	Other Comprehensive Income (Loss)	Stockholders' Equity
Balance, June 30, 2018	57,315,585	\$ 57	\$936,664	\$(239,054)	\$ (4,220)	\$ 693,447
Exercise of stock options	499,043	—	2,239	—	—	2,239
Issuance of common stock in connection with settlement of restricted stock units, net of withholdings	68,228	1	(44)	—	—	(43)
Issuance of common stock in connection with employee stock purchase plan	22,483	—	1,278	—	—	1,278
Stock-based compensation expense	—	—	7,933	—	—	7,933
Net loss	—	—	—	(9,944)	—	(9,944)
Foreign currency translation adjustment	—	—	—	—	(2,781)	(2,781)
Balance, September 30, 2018	57,905,339	\$ 58	\$948,070	\$(248,998)	\$ (7,001)	\$ 692,129

	Common Stock		Additional	Accumulated	Accumulated	Total
	Shares	Amount	Paid-In Capital	Deficit	Other Comprehensive Income (Loss)	Stockholders' Equity
Balance, December 31, 2017	52,505,856	\$ 53	\$588,289	\$(205,836)	\$ 5,326	\$ 387,832
Exercise of stock options	1,000,574	—	7,032	—	—	7,032
Issuance of common stock in connection with settlement of restricted stock units, net of withholdings	543,092	1	(3,451)	—	—	(3,450)
Issuance of common stock in connection with a public offering of common stock, net of offering costs	3,833,334	4	330,858	—	—	330,862
Issuance of common stock in connection with employee stock purchase plan	22,483	—	1,278	—	—	1,278
Stock-based compensation expense	—	—	24,064	—	—	24,064
Net loss	—	—	—	(43,162)	—	(43,162)
Foreign currency translation adjustment	—	—	—	—	(12,327)	(12,327)
Balance, September 30, 2018	57,905,339	\$ 58	\$948,070	\$(248,998)	\$ (7,001)	\$ 692,129

See accompanying notes to condensed consolidated financial statements.

Table of Contents

2U, Inc.

Condensed Consolidated Statements of Cash Flows
(unaudited, in thousands)

	Nine Months Ended September 30,	
	2018	2017
Cash flows from operating activities		
Net loss	\$(43,162)	\$(29,932)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	23,382	13,318
Stock-based compensation expense	24,064	15,537
Changes in operating assets and liabilities:		
Increase in accounts receivable, net	(35,543)	(33,915)
Increase in prepaid expenses and other assets	(5,426)	(1,638)
Increase in accounts payable and accrued expenses	10,796	6,101
Increase (decrease) in accrued compensation and related benefits	1,185	(1,447)
Increase in deferred revenue	12,210	11,723
Increase in payments to university clients	(11,066)	(12,146)
(Decrease) increase in other liabilities, net	(3,976)	5,349
Other	1,493	971
Net cash used in operating activities	(26,043)	(26,079)
Cash flows from investing activities		
Purchase of a business, net of cash acquired	—	(97,102)
Additions of amortizable intangible assets	(51,713)	(16,383)
Purchases of property and equipment	(8,027)	(20,924)
Purchase of investments	(25,000)	—
Advances repaid by university clients	25	—
Advances made to university clients	(300)	—
Net cash used in investing activities	(85,015)	(134,409)
Cash flows from financing activities		
Proceeds from issuance of common stock, net of offering costs	330,862	189,917
Proceeds from exercise of stock options	7,032	4,118
Tax withholding payments associated with settlement of restricted stock units	(3,450)	(1,310)
Proceeds from ESPP share purchases	1,278	—
Proceeds from debt	—	3,500
Payments on debt	—	(984)
Payments for acquisition of amortizable intangible assets	(4,900)	—
Net cash provided by financing activities	330,822	195,241
Effect of exchange rate changes on cash	(908)	(1,049)
Net increase in cash and cash equivalents	218,856	33,704
Cash and cash equivalents, beginning of period	223,370	168,730
Cash and cash equivalents, end of period	\$442,226	\$202,434

See accompanying notes to condensed consolidated financial statements.

Table of Contents

2U, Inc.

Notes to Condensed Consolidated Financial Statements
(unaudited)

1. Organization

2U, Inc. (together with its subsidiaries, the “Company”) is a leading education technology company that well-recognized nonprofit colleges and universities trust to bring them into the digital age. The Company’s comprehensive platform of tightly integrated technology and services provides the digital infrastructure universities need to attract, enroll, educate and support students at scale. With the Company’s platform, students can pursue their education anytime, anywhere, without quitting their jobs or moving; and university clients can improve educational outcomes, skills attainment and career prospects for a greater number of students.

The Company has two operating segments, which are also its two reportable segments: the Graduate Program Segment and the Short Course Segment. The Company’s Graduate Program Segment provides services to well-recognized nonprofit colleges and universities, primarily in the United States, to enable the online delivery of graduate programs. The Company’s Short Course Segment provides premium online short courses to working professionals around the world through relationships with leading universities in the United States, the United Kingdom and South Africa.

2. Significant Accounting Policies

Basis of Presentation and Principles of Consolidation

The accompanying unaudited condensed consolidated financial statements, which include the assets, liabilities, results of operations and cash flows of the Company have been prepared in accordance with: (i) generally accepted accounting principles in the United States (“U.S. GAAP”) for interim financial information; (ii) the instructions to Form 10-Q; and (iii) the guidance of Rule 10-01 of Regulation S-X under the Securities Exchange Act of 1934, as amended, for financial statements required to be filed with the Securities and Exchange Commission (“SEC”). As permitted under such rules, certain notes and other financial information normally required by U.S. GAAP have been condensed or omitted. The Company believes the condensed consolidated financial statements reflect all normal and recurring adjustments necessary for a fair statement of the Company’s financial position, results of operations, and cash flows as of and for the periods presented herein. The Company’s results of operations for the three and nine months ended September 30, 2018 and 2017 may not be indicative of the Company’s future results. These condensed consolidated financial statements are unaudited and should be read in conjunction with the Company’s audited consolidated financial statements and the notes thereto included in the Company’s Annual Report on Form 10-K for the fiscal year ended December 31, 2017. All significant intercompany accounts and transactions have been eliminated in consolidation.

The year-end condensed consolidated balance sheet data was derived from the audited financial statements, but does not include all disclosures required by U.S. GAAP on an annual reporting basis.

Reclassifications

Certain immaterial prior period amounts on the condensed consolidated balance sheet and statement of cash flows have been reclassified to conform to the current period’s presentation.

Use of Estimates

The preparation of the condensed consolidated financial statements in accordance with U.S. GAAP requires management to make certain estimates and assumptions that affect the amounts reported herein. The Company bases its estimates and assumptions on historical experience and on various other factors that it believes to be reasonable under the circumstances. Due to the inherent uncertainty involved in making estimates, actual results reported in future periods may be affected by changes in those estimates. The Company evaluates its estimates and assumptions on an ongoing basis.

Short-Term Investments

The Company's short-term investments relate to certificates of deposit with original maturities between three months and one year. As of September 30, 2018, the Company had a \$25.0 million certificate of deposit included in short-term investments that qualifies as a Level 1 fair value measurement asset and was stated at cost, which approximates fair value.

Table of Contents

Revenue Recognition, Accounts Receivable and Allowance for Doubtful Accounts

On January 1, 2018, the Company adopted ASU No. 2014-09, Revenue from Contracts with Customers (Topic 606) and the related amendments using the modified retrospective transition method and has concluded that doing so did not have a material impact on the amount and timing of either its revenue or costs. As part of its assessment, the Company completed reviews of its contracts and evaluated its costs, including costs of obtaining contracts with its university clients and costs associated with content development. Certain of these contract and content costs will be capitalized under the new standard. The adoption of ASU 2014-09 did not have a material impact as of January 1, 2018, and no cumulative adjustment was recorded. Further, the amounts reported as of September 30, 2018 on the condensed consolidated balance sheets and the results of operations for the three and nine months ended September 30, 2018 reported on the condensed consolidated statements of operations and comprehensive loss would not have been materially different than under legacy U.S. GAAP (i.e., Topic 605).

The Company generates substantially all of its revenue from contractual arrangements with either its university clients or students to provide a comprehensive platform of tightly integrated technology and technology-enabled services that support its graduate programs and short courses.

Performance Obligations

A performance obligation is a promise in a contract to transfer a distinct good or service to the customer. A contract's transaction price is allocated to each distinct performance obligation and recognized as revenue when, or as, the performance obligation is satisfied.

The Graduate Program Segment derives revenue primarily from contractually specified percentages of the amounts the Company's university clients receive from their students in 2U-enabled graduate programs for tuition and fees, less credit card fees and other specified charges the Company has agreed to exclude in certain university client contracts. The Company's contracts with university clients in this segment have 10 to 15 year initial terms and have a single performance obligation, as the promises to provide a platform of tightly integrated technology and services university clients need to attract, enroll, educate and support students are not distinct within the context of the contracts. The single performance obligation is delivered as the university clients receive and consume benefits, which occurs ratably over a series of academic terms. The amounts received from university clients over the term of the arrangement are variable in nature in that they are dependent upon the number of students that are enrolled in the program within each academic term. These amounts are allocated to and are recognized ratably over the related academic term, defined as the period beginning on the first day of classes through the last. A refund allowance is established for the Company's share of tuition and fees ultimately uncollected by university clients.

The Short Course Segment derives revenue directly from contracts with students for the tuition and fees paid to enroll in and progress through the Company's short courses which run between six and 16 weeks. The Company's contracts with students in this segment have multiple performance obligations as the delivery of the short course and student support services are each considered distinct performance obligations. These performance obligations are each satisfied ratably over the same short course presentation period, which is defined as the period beginning on the first day of the course through the last. The Company recognizes the gross proceeds received from the students and shares contractually specified percentages with its university clients, for providing short course content and certification, in the form of a royalty recognized as curriculum and teaching costs on the Company's condensed consolidated statements of operations and comprehensive loss. The Company's contracts with university clients in this segment are typically shorter and less restrictive than the Company's contracts with university clients in the Graduate Program Segment.

The Company does not disclose the value of unsatisfied performance obligations for the Graduate Program Segment because the variable consideration is allocated entirely to a wholly unsatisfied promise to transfer a service that forms part of a single performance obligation. The Company does not disclose the value of unsatisfied performance obligations for the Short Course Segment because the performance obligation is part of a contract that has an original duration of less than one year.

Table of Contents

Contract Acquisition Costs

The Company pays commissions to certain of its employees to obtain contracts with university clients in the Graduate Program Segment. These costs are capitalized and recorded on a contract-by-contract basis and amortized using the straight-line method over the expected life, which is generally the length of the contract.

With respect to contract acquisition costs in the Short Course Segment, the Company has elected to apply the practical expedient in ASC Topic 606 to expense these costs as incurred, as the terms of contracts with students in this segment are less than one year.

Payments to University Clients

Pursuant to certain of the Company's contracts in the Graduate Program Segment, the Company has made, or is obligated to make, payments to university clients in exchange for contract extensions and various marketing and other rights. Generally, these amounts are capitalized and amortized as contra revenue over the life of the contract, commencing on the later of when payment is due or when contract revenue recognition begins.

Accounts Receivable, Contract Assets and Liabilities

Balance sheet items related to contracts consist of accounts receivable, net and deferred revenue on the Company's condensed consolidated balance sheets. Included in accounts receivable, net are trade accounts receivable, which are comprised of billed and unbilled revenue. Accounts receivable, net is stated at net realizable value, and the Company utilizes the allowance method to provide for doubtful accounts based on management's evaluation of the collectability of the amounts due. The Company's estimates are reviewed and revised periodically based on historical collection experience and a review of the current status of accounts receivable, net. Historically, actual write-offs for uncollectible accounts have not significantly differed from prior estimates. The Company recognizes unbilled revenue when revenue recognition occurs in advance of billings. Unbilled revenue is recognized in the Graduate Program Segment because billings to university clients do not occur until after the academic term has commenced and final enrollment information is available. The Company's unbilled revenue represents contract assets.

Deferred revenue represents the excess of amounts billed or received as compared to amounts recognized in revenue on the condensed consolidated statements of operations and comprehensive loss as of the end of the reporting period, and such amounts are reflected as a current liability on the Company's condensed consolidated balance sheets. The Company generally receives payments for its share of tuition and fees from graduate program university clients early in each academic term and from short course students, either in full upon registration for the course or in full before the end of the course based on a payment plan, prior to completion of the service period. These payments are recorded as deferred revenue until the services are delivered or until the Company's obligations are otherwise met, at which time revenue is recognized.

Capitalized Content Development

The Company develops content for each offering on a course-by-course basis in conjunction with the faculty for each graduate program and short course. University clients and their faculty generally provide materials used for the course in an on-campus setting, including curricula, case studies and other reading materials, and presentations. The Company is responsible for the conversion of the materials into a format suitable for delivery through its online learning platform, including all expenses associated with this effort. With regard to the Graduate Program Segment, the development of content is part of the Company's single performance obligation and is considered a contract fulfillment cost.

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

Table of Contents

Marketing and Sales Costs

The majority of the marketing and sales costs incurred by the Company are directly related to acquiring students for its university clients' graduate programs, with lesser amounts related to acquiring students for its short courses and marketing and advertising efforts related to the Company's own brand. For the three and nine months ended September 30, 2018 and 2017, costs related to the Company's marketing and advertising of its own brand were not material. All such costs are expensed as incurred and reported in marketing and sales expense on the Company's condensed consolidated statements of operations and comprehensive loss.

As of September 30, 2018 and December 31, 2017, the Company had \$16.1 million and \$11.7 million, respectively, of accrued marketing costs included in accounts payable and accrued expenses on the Company's condensed consolidated balance sheets.

Non-Cash Long-Lived Asset Additions

During the nine months ended September 30, 2018, the Company had capital asset additions of \$70.7 million in property and equipment and capitalized technology and content development, of which \$6.1 million consisted of non-cash capital expenditures, primarily related to the acquisition of certain long-lived assets for which a liability was accrued.

During the nine months ended September 30, 2017, the Company had capital asset additions of \$49.6 million in property and equipment and capitalized technology and content development, of which \$12.3 million consisted of non-cash capital expenditures.

Recent Accounting Pronouncements

In August 2018, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2018-15, Intangibles—Goodwill and Other—Internal-Use Software (Subtopic 350-40): Customer's Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract, which requires customers in cloud computing arrangements that are service contracts to follow the internal-use software guidance in ASC 350-40 to determine which implementation costs to capitalize as assets or expense as incurred. The amendments in this ASU are effective for fiscal years beginning after December 15, 2019, with early adoption permitted. The Company adopted this ASU as of July 1, 2018 under the prospective method. Adoption of this standard did not have a material impact on the Company's condensed consolidated financial statements.

In July 2018, the FASB issued ASU No. 2018-09, Codification Improvements, which clarifies and corrects unintended applications of guidance, and makes improvements to several Accounting Standards Codification topics. The applicable amendments in this ASU will be effective for the Company in annual periods beginning after December 15, 2018. The Company is currently evaluating the impact that this standard will have on its consolidated financial position and related disclosures.

In June 2018, the FASB issued ASU No. 2018-07, Compensation—Stock Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting, which simplifies the accounting for share-based payments to nonemployees. The amendments in this ASU are effective for fiscal years beginning after December 15, 2018, with early adoption permitted. The Company is evaluating the impact that this standard will have on its consolidated financial position and related disclosures.

In January 2017, the FASB issued ASU No. 2017-04, Intangibles—Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment, which eliminates step two from the goodwill impairment test and requires an entity to recognize an impairment charge for the amount by which the carrying amount of a reporting unit exceeds its fair value, up to the amount of goodwill allocated to that reporting unit. The amendments in this ASU are effective for fiscal years beginning after December 15, 2019, with early adoption permitted. The Company is evaluating the impact that this standard will have on its consolidated financial position and related disclosures.

In August 2016, the FASB issued ASU No. 2016-15, Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments. The ASU addresses eight specific cash flow issues with the objective of reducing the existing diversity in practice surrounding how certain transactions are classified in the statement of cash flows. The amendments in this ASU were effective for fiscal years beginning after December 15, 2017. The Company adopted this ASU on January 1, 2018. Adoption of this standard did not have a material impact on the Company's condensed consolidated statements of cash flows and related disclosures.

Table of Contents

In February 2016, the FASB issued ASU No. 2016-02, Leases (Topic 842). The ASU introduces a model for lessees requiring most leases to be reported on the balance sheet. The amendments in this ASU are effective for fiscal years beginning after December 15, 2018, and the Company will adopt this ASU in the first quarter of 2019. In July 2018, the FASB issued ASU No. 2018-10, Codification Improvements to Topic 842, Leases and ASU No. 2018-11, Leases (Topic 842): Targeted Improvements. ASU No. 2018-10 clarifies ambiguous or potentially conflicting guidance in ASU No. 2016-02, but is not expected to have a material impact on the Company. ASU No. 2018-11 provides entities with an additional transition method to adopt Topic 842. Under the new transition method, an entity initially applies the new lease standard at the adoption date, rather than at the beginning of the earliest period presented, and recognizes a cumulative-effect adjustment to the opening balance of retained earnings in the period of adoption. The Company expects to elect this transition method at the adoption date of January 1, 2019.

A number of optional practical expedients may be applied in transition. The Company is currently in the process of evaluating if it will elect any of the other remaining practical expedient options. The Company does not intend to recognize right-of-use assets or lease liabilities for leases with a term of 12 months or less, as permitted by the short-term lease practical expedient. In transition, the Company plans to apply the package of practical expedients that permit entities to not reassess (i) whether expired or existing contracts contain a lease under the new standard, (ii) the lease classification for expired or existing leases, or (iii) whether previously capitalized initial direct costs would qualify for capitalization under the new standard. The Company plans to apply the practical expedient that permits a lessee to account for lease and non-lease components in a contract as a single lease component. In addition, the Company does not intend to use hindsight during transition.

The Company is currently evaluating the effect that this ASU will have on its consolidated financial position and related disclosures and is in the process of considering changes to its systems and processes. The Company expects there will be an increase in assets and liabilities on the consolidated balance sheets upon adoption due to the recording of right-of-use assets and corresponding lease-related liabilities, which may be material. Refer to Note 7 in “Notes to Consolidated Financial Statements” included in Part II, Item 8 of the Company’s Annual Report on Form 10-K for the fiscal year ended December 31, 2017 for more information about the Company’s lease-related obligations.

Table of Contents

3. Business Combination

On July 1, 2017, the Company, through a wholly owned subsidiary (“2U South Africa”), completed its acquisition of all of the outstanding equity interests of GetSmarter pursuant to a Share Sale Agreement, dated as of May 1, 2017 (the “Share Sale Agreement”), as amended by an addendum, dated as of June 29, 2017, for a net purchase price of \$98.7 million in cash. In addition, 2U South Africa agreed to pay a potential earn out payment of up to \$20.0 million, subject to the achievement of certain financial milestones in calendar years 2017 and 2018. The valuation of the assets acquired and liabilities assumed (i.e., purchase price allocation) was completed as of December 31, 2017. As of September 30, 2018, there has been no material change in the expected earnout payment from the final valuation of the purchase price allocation since December 31, 2017.

The unaudited pro forma combined financial information below is presented for illustrative purposes and does not purport to represent what the results of operations would actually have been if the business combination occurred as of the dates indicated or what the results would be for any future periods. The following table presents the Company’s unaudited pro forma combined revenue, pro forma combined net loss and pro forma combined net loss per share for the nine months ended September 30, 2017 as if the acquisition of GetSmarter had occurred on January 1, 2017:

	Nine Months Ended September 30, 2017 (in thousands, except per share amounts)	
Pro forma revenue	\$ 207,768	
Pro forma net loss	(34,306)
Pro forma net loss per share, basic and diluted	\$ (0.72)

For the three months ended September 30, 2017, the Company’s unaudited pro forma combined revenue, pro forma combined net loss and pro forma combined net loss per share are equal to the Company’s consolidated revenue, net loss and net loss per share, respectively, as the acquisition of GetSmarter occurred on July 1, 2017.

4. Goodwill and Amortizable Intangible Assets

The table below summarizes the changes in the carrying amount of goodwill by reportable segment:

Reportable Segment	Gross Goodwill	Short-Term Course Programs	Total
	(in thousands)		
Balance as of December 31, 2017	\$ 71,988		\$ 71,988
Foreign currency translation adjustments	—(9,033)	(9,033)
Balance as of September 30, 2018	\$ 62,955		\$ 62,955

Amortizable intangible assets consisted of the following as of:

	September 30, 2018			December 31, 2017			
Estimated Average Useful Life (in years) (in thousands)	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	
Capitalized technology	3-5	\$63,789	\$ (14,593)	\$49,196	\$27,108	\$ (9,486)	\$17,622
Capitalized content development	4-5	73,428	(28,758)	44,670	55,872	(21,417)	34,455
University client relationships	9	26,033	(3,616)	22,417	29,443	(1,636)	27,807
Trade names and domain names	10	16,852	(2,443)	14,409	12,119	(1,242)	10,877

Total amortizable intangible
assets, net

\$180,102 \$ (49,410) \$130,692 \$124,542 \$ (33,781) \$90,761

Table of Contents

The amounts presented above include \$32.4 million and \$15.6 million of in process capitalized technology and content development as of September 30, 2018 and December 31, 2017, respectively.

In the first half of 2018, the Company acquired certain third party technologies to enhance the Company's proprietary operating system, 2UOS, for aggregate consideration of \$9.5 million. These amounts are classified as capitalized technology within amortizable intangible assets, net, on the Company's condensed consolidated balance sheets. Additionally, during the same period the Company purchased several active websites and additional domains for consideration of \$5.7 million to support the marketing efforts of certain graduate programs. As of September 30, 2018, these acquired assets are classified in trade names and domain names within amortizable intangible assets, net, on the Company's condensed consolidated balance sheets.

In the first quarter of 2018, the Company entered into an agreement with WeWork Companies, Inc. ("WeWork") and Flatiron School, Inc., a wholly owned subsidiary of WeWork, to purchase a perpetual source code license for the Learn.co platform and certain integration software development services for \$14.5 million. As of September 30, 2018, the Company has recorded capitalized technology of \$13.2 million related to this agreement in amortizable intangible assets, net on the Company's condensed consolidated balance sheets. The remaining \$1.3 million is payable under the agreement upon the achievement of certain milestones related to the software development services. In addition, the Company entered into a multi-year agreement to purchase Global Access Memberships to WeWork spaces around the world that will be provided to students in 2U-powered online graduate programs, an agreement to offer \$5 million in scholarships to certain WeWork community members and employees, and collaborate on additional mutually agreed upon projects.

The Company recorded amortization expense related to amortizable intangible assets of \$6.4 million and \$3.6 million for the three months ended September 30, 2018 and 2017, respectively. The Company recorded amortization expense related to amortizable intangible assets of \$17.1 million and \$8.7 million for the nine months ended September 30, 2018 and 2017, respectively. As of September 30, 2018, the estimated future amortization expense for amortizable intangible assets placed in service is as follows (in thousands):

Remainder of 2018	\$6,094
2019	23,015
2020	19,996
2021	15,503
2022	11,688
Thereafter	22,043
Total	\$98,339

5. Commitments and Contingencies

Legal Contingencies

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

Marketing and Sales Commitments

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

Table of Contents

Future Minimum Payments to University Clients

Pursuant to certain of the Company's contracts in the Graduate Program Segment, the Company has made, or is obligated to make, payments to university clients in exchange for contract extensions and various marketing and other rights. As of September 30, 2018, the future minimum payments due to university clients has not materially changed relative to the amounts provided in the notes to the consolidated financial statements included in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2017.

Contingent Payments to University Clients

Pursuant to certain of the Company's contracts in the Graduate Program Segment, the Company would be obligated to make future minimum program payments to a university client in the event that certain program metrics, partially associated with programs not yet launched, are not achieved. Due to the dependency of these calculations on future program launches, the amounts of any associated contingent payments cannot be reasonably estimated at this time.

Table of Contents

6. Debt

Lines of Credit

Effective in the third quarter of 2018, the Company amended its \$25.0 million revolving line of credit agreement to extend the maturity date through December 31, 2018. No amounts were outstanding under this credit agreement as of September 30, 2018 or December 31, 2017. The Company intends to amend or extend this agreement under comparable or more favorable terms, prior to expiration.

Certain of the Company's operating lease agreements entered into prior to September 30, 2018 require security deposits in the form of cash or an unconditional, irrevocable letter of credit. As of September 30, 2018, the Company has entered into standby letters of credit totaling \$15.0 million as security deposits for the applicable leased facilities and in connection with government grants. These letters of credit reduced the aggregate amount the Company may borrow under its revolving line of credit to \$10.0 million.

The Company's \$1.9 million revolving debt facilities related to the Short Course Segment expired on March 31, 2018 and were not renewed.

Government Grants

The Company has a total of two outstanding conditional loan agreements with Prince George's County, Maryland and the State of Maryland for an aggregate amount of \$3.5 million, each bearing an interest rate of 3% per annum. These agreements are conditional loan obligations that may be forgiven provided that the Company attains certain conditions related to employment levels at our Lanham, Maryland headquarters. The conditional loan with the State of Maryland has a maturity date of December 31, 2026, and the conditional loan with Prince George's County, Maryland has a maturity date of June 22, 2027. The interest expense related to these loans for the three and nine months ended September 30, 2018 and 2017 is immaterial.

7. Income Taxes

The Company's income tax provisions for all periods consist of federal, state and foreign income taxes. The tax provisions for the three and nine months ended September 30, 2018 and 2017 were based on estimated full-year effective tax rates, including the mix of income for the period between higher-taxed and lower-taxed jurisdictions, after giving effect to significant items related specifically to the interim periods, and loss-making entities for which it is not more likely than not that a tax benefit will be realized.

The Company's effective tax rate was approximately 4% and 6% for the three months ended September 30, 2018 and 2017, respectively. The Company's effective tax rate was approximately 11% and 3% for the nine months ended September 30, 2018 and 2017, respectively. A one-time tax benefit of approximately \$3.0 million related to an asset acquisition of certain third-party technologies is included in the Company's income tax benefit for the nine months ended September 30, 2018. This benefit relates to the reversal of the Company's tax valuation allowance that was no longer needed as a result of establishing a net deferred tax liability. Excluding the one-time tax benefit, the Company's tax benefit of \$0.4 million and \$2.2 million for the three and nine months ended September 30, 2018, respectively, related to losses generated by operations and the amortization of acquired intangibles in the Short Course Segment that are expected to be realized through future reversing taxable temporary differences. The Company expects to continue to recognize a tax benefit in the future for the Short Course Segment to the extent that this segment continues to generate pre-tax losses while carrying deferred tax liabilities that are in excess of deferred tax assets. To date, the Company has not been required to pay U.S. federal income taxes because of current and

accumulated net operating losses.

On December 22, 2017, Staff Accounting Bulletin No. 118 (“SAB 118”) was issued to address the application of U.S. GAAP in situations when a registrant does not have the necessary information available, prepared, or analyzed (including computations) in reasonable detail to complete the accounting for certain income tax effects of the Tax Cuts and Jobs Act of 2017 (“Tax Act”). As of September 30, 2018, the Company finalized its assessment of the Tax Act, including its determination that no transitional tax is required.

16

Table of Contents

8. Stockholders' Equity

On May 22, 2018 the Company sold 3,833,334 shares of its common stock to the public, including 500,000 shares sold pursuant to the underwriters' over-allotment option. The Company received net proceeds of \$330.8 million, which the Company intends to use for working capital and other general corporate purposes, including expenditures for graduate program and short course marketing, technology and content development, in connection with new graduate program and short course launches and growing existing graduate programs and short courses as well as the strategic acquisitions of, or investment in, complementary products, technologies, solutions or businesses.

As of September 30, 2018, 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. As of September 30, 2018, the Company had reserved a total of 12,431,835 of its authorized shares of common stock for future issuance as follows:

Outstanding stock options	4,097,480
Possible future issuance under 2014 Equity Incentive Plan	6,139,677
Outstanding restricted stock units	1,217,161
Available for future issuance under employee stock purchase plan	977,517
Total shares of common stock reserved for future issuance	12,431,835

The shares available for future issuance increased by 2,625,292 and 2,357,579 on January 1, 2018 and 2017, respectively, pursuant to the automatic share reserve increase provision under the Amended and Restated 2014 Equity Incentive Plan (the "2014 Plan"). The Company has not declared or paid cash dividends on its common stock to date.

9. Stock-Based Compensation

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

Employee Stock Purchase Plan

The Company's 2017 Employee Stock Purchase Plan (the "ESPP") provides (i) for two offering periods each year and (ii) that the purchase price for shares of the Company's common stock purchased under the ESPP will be 90% of the lesser of the fair market value of 2U's common stock on the purchase date or the fair market value of 2U's common stock on the first day of the offering period. Participating eligible employees select a rate of payroll deduction between 1% and 15% of their salary or wage compensation received from the Company as in effect at the start of the offering period, subject to a maximum payroll deduction per calendar year of \$25,000. Participation in the ESPP began on January 1, 2018.

Stock-Based Compensation Expense

Stock-based compensation expense related to stock-based awards, as well as the ESPP, is included in the following line items in the condensed consolidated statements of operations and comprehensive loss:

	Three Months	Nine Months		
	Ended	Ended		
	September 30,	September 30,		
	2018	2017	2018	2017

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

	(in thousands)			
Curriculum and teaching	\$3	\$2	\$10	\$2
Servicing and support	1,346	1,100	3,538	2,956
Technology and content development	1,089	904	2,875	2,447
Marketing and sales	839	463	2,046	1,235
General and administrative	4,656	3,678	15,595	8,897
Total stock-based compensation expense	\$7,933	\$6,147	\$24,064	\$15,537

17

Table of Contents

Stock Options

The following is a summary of the stock option activity for the nine months ended September 30, 2018:

	Number of Options	Weighted-Average Exercise Price per Share
Outstanding balance at December 31, 2017	4,559,176	\$ 15.10
Granted	663,615	84.13
Exercised	(1,000,574)	7.03
Forfeited	(124,737)	41.20
Expired	—	—
Outstanding balance at September 30, 2018	4,097,480	27.45
Exercisable at September 30, 2018*	2,814,863	13.34

*As of September 30, 2018, the aggregate intrinsic value of options exercisable was \$174.2 million and such shares had a weighted-average remaining contractual term of 5.08 years.

Restricted Stock Units

The following is a summary of restricted stock unit activity for the nine months ended September 30, 2018:

	Number of Restricted Stock Units	Weighted- Average Grant Date Fair Value
Outstanding balance at December 31, 2017	1,413,423	\$ 29.95
Granted	523,281	81.74
Vested	(585,799)	25.54
Forfeited	(133,744)	43.98
Outstanding balance at September 30, 2018	1,217,161	52.80

10. Net Loss per Share

Diluted net loss per share is the same as basic net loss per share for all periods presented because the effects of potentially dilutive items were anti-dilutive, given the Company's net loss. The following securities have been excluded from the calculation of weighted-average shares of common stock outstanding because the effect is anti-dilutive for the three and nine months ended September 30, 2018 and 2017:

	Three and Nine Months Ended September 30, 2018		2017
Stock options	4,097,480	4,912,509	
Restricted stock units	1,217,161	1,435,180	

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

	Three Months Ended September 30, 2018		Nine Months Ended September 30, 2018	
	2018	2017	2018	2017
Numerator (in thousands):				
Net loss	\$ (9,944)	\$ (14,739)	\$ (43,162)	\$ (29,932)

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

Denominator:

Weighted-average shares of common stock outstanding, basic and diluted	57,663,364	48,961,914	55,128,845	47,962,201
Net loss per share, basic and diluted	\$(0.17)	\$(0.30)	\$(0.78)	\$(0.62)

18

Table of Contents

11. Segment and Geographic Information

The Company's operations consist of two operating segments, which are also its two reportable segments: the Graduate Program Segment and the Short Course Segment. The Company's Graduate Program Segment provides services to well-recognized nonprofit colleges and universities, primarily in the United States, to enable the online delivery of graduate programs. The Company's Short Course Segment provides premium online short courses to working professionals around the world through relationships with leading universities in the United States, the United Kingdom and South Africa.

Graduate Program Segment

For the three months ended September 30, 2018, three university clients each accounted for 10% or more of the Company's consolidated revenue, as follows: \$24.0 million, \$13.0 million and \$10.8 million which equaled 22%, 12% and 10% of the Company's consolidated revenue, respectively. For the three months ended September 30, 2017, four university clients each accounted for 10% or more of the Company's consolidated revenue, as follows: \$19.6 million, \$10.8 million, \$7.2 million and \$7.1 million, which equaled 28%, 15%, 10% and 10% of the Company's consolidated revenue, respectively.

For the nine months ended September 30, 2018, three university clients each accounted for 10% or more of the Company's consolidated revenue, as follows: \$65.0 million, \$39.5 million and \$30.6 million, which equaled 22%, 13% and 10% of the Company's consolidated revenue, respectively. For the nine months ended September 30, 2017, four university clients each accounted for 10% or more of the Company's consolidated revenue, as follows: \$58.4 million, \$34.6 million, \$21.0 million and \$20.3 million, which equaled 30%, 17%, 11% and 10% of the Company's consolidated revenue, respectively.

As of September 30, 2018, two university clients each accounted for 10% or more of the Company's consolidated accounts receivable, net balance, as follows: \$13.4 million and \$7.0 million, which equaled 27% and 14% of the Company's consolidated accounts receivable, net balance, respectively. As of December 31, 2017, two university clients each accounted for 10% or more of the Company's consolidated accounts receivable, net balance, as follows: \$9.4 million and \$2.0 million, which equaled 67% and 14% of the Company's consolidated accounts receivable, net balance, respectively.

Short Course Segment

For the three and nine months ended September 30, 2018 and 2017, there were no customers or individual university clients that had revenue associated with it that accounted for 10% or more of the Company's consolidated revenue. In addition, as of September 30, 2018 and December 31, 2017, no customers had accounts receivable, net balances that accounted for 10% or more of the Company's consolidated accounts receivable, net balance, as customers are individual students or third parties paying on their behalf, rather than university clients.

For the three months ended September 30, 2018, offerings associated with four university clients each accounted for 10% or more of the segment's revenue, and when combined, accounted for approximately 91% of the segment's revenue. For the three months ended September 30, 2017, offerings associated with two university clients each accounted for 10% or more of the segment's revenue, and when combined, accounted for approximately 82% of the segment's revenue.

For the nine months ended September 30, 2018, offerings associated with three university clients each accounted for 10% or more of the segment's revenue, and when combined, accounted for approximately 82% of the segment's

revenue. For the nine months ended September 30, 2017, offerings associated with two university clients each accounted for 10% or more of the segment's revenue, and when combined, accounted for approximately 82% of the segment's revenue.

Table of Contents

Segment Performance

The following table summarizes financial information regarding each reportable segment's results of operations for the periods presented:

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2018	2017	2018	2017
	(in thousands)			
Revenue by segment*				
Graduate Program Segment	\$89,719	\$65,924	\$251,487	\$195,748
Short Course Segment	17,244	4,326	45,187	4,326
Total revenue	\$106,963	\$70,250	\$296,674	\$200,074
Segment profitability**				
Graduate Program Segment	\$5,564	\$(718)	\$(615)	\$1,693
Short Course Segment	(889)	(3,002)	(1,787)	(3,002)
Total segment profitability	\$4,675	\$(3,720)	\$(2,402)	\$(1,309)
Segment profitability margin***				
Graduate Program Segment	5.2	% (1.0)	% (0.2)	% 0.8
Short Course Segment	(0.8)	(4.3)	(0.6)	(1.5)
Total segment profitability margin	4.4	% (5.3)	% (0.8)	% (0.7)

* The Company has excluded approximately \$44,000 of intersegment revenues from the three and nine months ended September 30, 2018.

The Company defines segment profitability as net income or net loss, as applicable, before net interest income (expense), taxes, depreciation and amortization, foreign currency gains or losses, acquisition-related gains or losses and stock-based compensation expense. Some or all of these items may not be applicable in any given reporting period.

*** The Company defines segment profitability margin as segment profitability as a percentage of consolidated revenue.

The following table reconciles net loss to total segment profitability:

	Three Months		Nine Months Ended	
	Ended		September 30,	
	2018	2017	2018	2017
	(in thousands)			
Net loss	\$(9,944)	\$(14,739)	\$(43,162)	\$(29,932)
Adjustments:				
Interest income	(1,799)	(18)	(3,053)	(267)
Interest expense	27	36	81	37
Foreign currency loss (gain)	273	(59)	1,493	972
Depreciation and amortization expense	8,599	5,887	23,382	13,318
Income tax benefit	(414)	(974)	(5,207)	(974)
Stock-based compensation expense	7,933	6,147	24,064	15,537
Total adjustments	14,619	11,019	40,760	28,623
Total segment profitability	\$4,675	\$(3,720)	\$(2,402)	\$(1,309)

The Company's total assets by segment are as follows:

September 30, December 31,
2018 2017
(in thousands)

Total assets		
Graduate Program Segment	\$ 700,978	\$ 359,597
Short Course Segment	110,513	122,465
Total assets	\$ 811,491	\$ 482,062

20

Table of Contents

Trade Accounts Receivable and Contract Liabilities

The Company's trade accounts receivable and contract liabilities in each segment are as follows:

	September 30, 2018		December 31, 2017	
	(in thousands)			
Trade accounts receivable				
Graduate Program Segment accounts receivable, net	\$22,397		\$ 12,520	
Graduate Program Segment unbilled revenue	25,583		666	
Short Course Segment accounts receivable, net	1,435		988	
Total trade accounts receivable	\$49,415		\$ 14,174	
Contract liabilities				
Graduate Program Segment deferred revenue	\$9,607		\$ 2,523	
Short Course Segment deferred revenue	9,346		4,501	
Total contract liabilities	\$18,953		\$ 7,024	

For the Graduate Program Segment, revenue recognized during the three and nine months ended September 30, 2018 that was included in the deferred revenue balance at the beginning of the year was \$0.0 million and \$2.5 million, respectively. For the Short Course Segment, revenue recognized during the three and nine months ended September 30, 2018 that was included in the deferred revenue balance at the beginning of the year was \$0.0 million and \$4.5 million, respectively.

Contract Acquisition Costs

The Graduate Program Segment had \$0.3 million of net capitalized contract acquisition costs as of September 30, 2018. For the three months ended September 30, 2018, the Company capitalized no amounts and recorded an immaterial amount of amortization expense in the Graduate Program Segment. For the nine months ended September 30, 2018, the Company capitalized \$0.3 million and recorded an immaterial amount of amortization expense in the Graduate Program Segment.

Geographical Information

The Company's non-U.S. revenue for the three and nine months ended September 30, 2018, determined based upon the currency of the country in which the university client primarily operates, was \$8.8 million and \$26.0 million, respectively, and was sourced entirely from the Short Course Segment's operations outside of the U.S. The Company's non-U.S. revenue for both the three and nine months ended September 30, 2017, determined based upon the currency of the country in which the university client primarily operates, was \$3.0 million, and was sourced entirely from the Short Course Segment's operations outside of the U.S. The Company's long-lived assets in non-U.S. countries as of September 30, 2018 and December 31, 2017 totaled approximately \$1.3 million and \$0.7 million, respectively.

Table of Contents

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

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our condensed consolidated financial statements and the related notes to those statements included elsewhere in this Quarterly Report on Form 10-Q and our Annual Report on Form 10-K for the year ended December 31, 2017. Certain statements contained in this Quarterly Report on Form 10-Q may constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934 (the “Exchange Act”), as amended. The words or phrases “would be,” “will allow,” “intends to,” “will likely result,” “are expected to,” “will continue,” “is anticipated,” “estimate,” “project,” or similar expressions, or the negative of such words or phrases, are intended to identify “forward-looking statements.” We have based these forward-looking statements on our current expectations and projections about future events. Because such statements include risks and uncertainties, actual results may differ materially from those expressed or implied by such forward-looking statements. Many factors could cause or contribute to these differences, including those discussed in Item 1A, “Risk Factors” in this Quarterly Report on Form 10-Q and in our Annual Report on Form 10-K for the year ended December 31, 2017, and our other filings with the Securities and Exchange Commission, or “SEC.” Statements made herein are as of the date of the filing of this Form 10-Q with the SEC and should not be relied upon as of any subsequent date. Unless otherwise required by applicable law, we do not undertake, and we specifically disclaim, any obligation to update any forward-looking statements to reflect occurrences, developments, unanticipated events or circumstances after the date of such statement.

Unless the context otherwise requires, all references to the “we”, “us” or “our” refer to 2U, Inc., together with its subsidiaries. The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our unaudited condensed consolidated financial statements and related notes that appear in Item 1 of this Quarterly Report on Form 10-Q and with our audited consolidated financial statements and related notes for the year ended December 31, 2017, which are included in our Annual Report on Form 10-K, filed with the SEC on February 27, 2018.

Overview

Our Business

We are a leading education technology company that well-recognized nonprofit colleges and universities trust to bring them into the digital age. Our comprehensive platform of tightly integrated technology and services provides the digital infrastructure universities need to attract, enroll, educate and support students at scale. With our platform, students can pursue their education anytime, anywhere, without quitting their jobs or moving; and university clients can improve educational outcomes, skills attainment and career prospects for a greater number of students.

We have two reportable segments: the Graduate Program Segment and the Short Course Segment.

Our Graduate Program Segment provides services to well-recognized nonprofit colleges and universities, primarily in the United States, to enable the online delivery of graduate programs. We target students seeking a full graduate degree of the same quality they would receive on-campus.

Our Short Course Segment provides premium online short courses to working professionals in more than 150 countries. We target working professionals seeking career advancement through skills attainment.

Our core strategy is to launch graduate programs and short courses with new and existing university clients and to increase student enrollments across our portfolio of offerings. We are also committed to continuously improving our platform to deliver high-quality university and student experiences and outcomes at scale.

Our Business Model and Components of Operating Results

The key elements of our business model and components of our operating results are described below.

Revenue

Graduate Program Segment

Our Graduate Program Segment derives revenue primarily from contractually specified percentages of the amounts our university clients receive from their students for tuition and fees, less credit card fees and other agreed-upon charges. Most of our contracts with university clients in this segment are long-term and typically have 10 to 15 year initial terms.

Table of Contents

Short Course Segment

Our Short Course Segment derives revenue directly from contracts with students for the tuition and fees paid to enroll in and progress through our short courses. Contractually specified percentages of the gross proceeds received from students are shared with the university clients, in the form of a royalty recognized on our condensed consolidated statements of operations and comprehensive loss as curriculum and teaching costs. Our contracts with university clients in this segment are typically shorter and less restrictive than our contracts with university clients in our Graduate Program Segment.

Operating Costs

Our operating costs consist of the following:

Curriculum and teaching. Curriculum and teaching costs are associated with our Short Course Segment and primarily relate to royalties due to our university clients, which are based on contractually specified percentages of the gross proceeds associated with our short course offerings. It also includes costs to compensate short course tutors.

Servicing and support. Servicing and support costs consist primarily of cash and non-cash compensation and benefit costs (including stock-based compensation). It also includes software licensing, telecommunications, technical support and other costs related to providing access to and support for our platform for our university clients and students. In addition, servicing and support includes costs to facilitate in-program field placements, student immersions and other student enrichment experiences, as well as costs to assist our university clients with their state compliance requirements.

Technology and content development. Technology and content development costs consist primarily of cash and non-cash compensation and benefit costs (including stock-based compensation) and outsourced services costs related to the ongoing improvement and maintenance of our platform, and the developed content for our graduate programs and short courses. It also includes the associated amortization expense related to capitalized technology and content development, as well as hosting and other costs associated with maintaining our platform in a cloud environment. Additionally, it includes the costs to support our internal infrastructure, including our cloud-based server usage.

Marketing and sales. Marketing and sales costs consist primarily of student acquisition activities across both of our segments. This includes the cost of online advertising and demand generation, as well as cash and non-cash compensation and benefit costs (including stock-based compensation) for our graduate program and short course marketing, marketing analytics and admissions application counseling personnel.

General and administrative. General and administrative costs consist primarily of cash and non-cash compensation and benefit costs (including stock-based compensation) for employees in our executive, administrative, finance and accounting, legal, communications and human resources functions. It also includes external legal, accounting and other professional fees, telecommunications charges and other corporate costs such as insurance and travel that are not related to another function.

Table of Contents

Results of Operations

Third Quarter 2018 Highlights

Revenue was \$107.0 million, an increase of 52.3% from \$70.3 million in the third quarter of 2017.

Net loss was \$(9.9) million, or \$(0.17) per share, compared to \$(14.7) million or \$(0.30) per share, in the third quarter of 2017.

Adjusted EBITDA was \$4.7 million, compared to an adjusted EBITDA loss of \$(3.7) million in the third quarter of 2017.

We launched five new graduate programs.

Consolidated Operating Results

Comparison of Three Months Ended September 30, 2018 and 2017

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

	Three Months Ended September 30,							
	2018		2017		Period-to-Period Change			
	Amount	Percentage of Revenue	Amount	Percentage of Revenue	Amount	Percentage		
	(dollars in thousands)							
Revenue	\$106,963	100.0 %	\$70,250	100.0 %	\$36,713	52.3 %		
Costs and expenses								
Curriculum and teaching	6,351	5.9	1,792	2.6	4,559	254.5		
Servicing and support	16,586	15.5	12,939	18.4	3,647	28.2		
Technology and content development	16,361	15.3	12,735	18.1	3,626	28.5		
Marketing and sales	60,548	56.5	41,311	58.8	19,237	46.6		
General and administrative	18,974	17.7	17,227	24.5	1,747	10.1		
Total costs and expenses	118,820	110.9	86,004	122.4	32,816	38.2		
Loss from operations	(11,857)	(10.9)	(15,754)	(22.4)	3,897	(24.7)		
Interest income	1,799	1.7	18	—	1,781	*		
Interest expense	(27)	—	(36)	(0.1)	9	(25.0)		
Other income (expense), net	(273)	(0.3)	59	0.1	(332)	*		
Loss before income taxes	(10,358)	(9.5)	(15,713)	(22.4)	5,355	(34.1)		
Income tax benefit	414	0.4	974	1.4	(560)	42.4		
Net loss	\$(9,944)	(9.1)	\$(14,739)	(21.0)	\$4,795	67.4		

*Not meaningful for comparative purposes.

The following table sets forth the revenue by segment for each of the periods indicated.

Revenue by segment*	Three Months Ended September 30,		Period-to-Period Change		Amount	Percentage
	2018	2017				
	(in thousands)					
Graduate Program Segment	\$89,719	\$65,924	\$23,795	36.1 %		

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

Short Course Segment	17,244	4,326	12,918	298.6
Total revenue	\$106,963	\$70,250	\$36,713	52.3

*Approximately \$44,000 of intersegment revenues have been excluded from the three months ended September 30, 2018.

Table of Contents

Revenue. Revenue for the three months ended September 30, 2018 was \$107.0 million, an increase of \$36.7 million, or 52.3%, from \$70.3 million for the same period of 2017. Graduate Program Segment revenue increased by \$23.8 million, or 36.1%. This increase was primarily driven by growth in full course equivalent enrollments of 8,603, or 35.8% and, to a lesser extent, an increase in the average revenue per full course equivalent enrollment, from \$2,740 to \$2,747. Short Course Segment revenue increased by \$12.9 million, or 298.6%. This increase was primarily driven by growth in full course equivalent enrollments of 4,858, or 119.1% and, to a lesser extent, an increase in the average revenue per full course equivalent enrollment, from \$1,232 to \$1,930. Fluctuations in foreign currency exchange rates from those prevailing in the same period of 2017, did not have a material impact on revenue.

Curriculum and teaching. Curriculum and teaching costs for the three months ended September 30, 2018 were \$6.4 million, an increase of \$4.6 million, or 254.5%, from \$1.8 million for the same period of 2017. This was primarily due to an increase in the number of short courses taken in our Short Course Segment.

Servicing and support. Servicing and support costs for the three months ended September 30, 2018 were \$16.6 million, an increase of \$3.6 million, or 28.2%, from \$12.9 million for the same period of 2017. This was primarily due to a \$2.8 million increase in cash and non-cash compensation and benefit costs, as we increased our headcount in servicing and support by 38% to serve a growing number of students and faculty in existing and new graduate programs and short courses. Additionally, \$0.9 million of the increase primarily related to higher student immersion costs and, to a lesser extent, rent and other servicing and support costs.

Technology and content development. Technology and content development costs for the three months ended September 30, 2018 were \$16.4 million, an increase of \$3.6 million, or 28.5%, from \$12.7 million for the same period of 2017. The increase was due in part to a \$0.8 million increase in cash and non-cash compensation and benefit costs (net of amounts capitalized for technology and content development), as we increased our headcount in technology and content development by 48% to support the scaling of existing and launching of new graduate programs and short courses. Additionally, \$1.8 million of the increase related to higher amortization expense associated with capitalized technology and content development, and \$1.0 million of the increase related to higher hosting and licensing costs, due to the larger number of courses that have been developed and the continued maintenance of our platform in a cloud environment.

Marketing and sales. Marketing and sales costs for the three months ended September 30, 2018 were \$60.5 million, an increase of \$19.2 million, or 46.6%, from \$41.3 million for the same period of 2017. The increase was primarily due to higher direct internet marketing costs of \$11.8 million to drive enrollments in our graduate programs and short courses. Additionally, the increase included \$6.3 million of higher cash and non-cash compensation and benefit costs, as we increased our headcount in marketing and sales by 38% to drive enrollment and revenue growth in existing and new graduate programs and short courses. The remaining \$1.0 million of the increase related to higher other marketing and sales costs.

General and administrative. General and administrative costs for the three months ended September 30, 2018 were \$19.0 million, an increase of \$1.8 million, or 10.1%, from \$17.2 million for the same period of 2017. This was primarily due to a \$2.8 million increase in cash and non-cash compensation and benefit costs, as we increased our headcount in general and administrative by 36% to support our growing business and, to a lesser extent, higher rent and other facilities costs, partially offset by a \$1.1 million decrease in consulting, other professional services and travel costs.

Net Interest Income (Expense). In the three months ended September 30, 2018, we earned net interest income of \$1.8 million, compared to net interest expense of \$18,000 in the same period of 2017, primarily driven by a higher cash balance resulting from our May 2018 public offering of common stock.

Other Income (Expense), Net. For the three months ended September 30, 2018, we incurred other expense, net, of \$0.3 million, compared to other income, net of \$0.1 million in the same period of 2017.

Comparison of Nine Months Ended September 30, 2018 and 2017

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

25

Table of Contents

	Nine Months Ended September 30,						Period-to-Period Change	
	2018		2017		Amount	Percentage	Amount	Percentage
	Amount	Percentage of Revenue	Amount	Percentage of Revenue				
	(dollars in thousands)							
Revenue	\$296,674	100.0 %	\$200,074	100.0 %	\$96,600	48.3 %		
Costs and expenses								
Curriculum and teaching	16,665	5.6	1,792	0.9	14,873	830.1		
Servicing and support	49,116	16.6	37,322	18.7	11,794	31.6		
Technology and content development	45,436	15.3	33,080	16.5	12,356	37.4		
Marketing and sales	171,982	58.0	113,223	56.6	58,759	51.9		
General and administrative	63,323	21.3	44,821	22.4	18,502	41.3		
Total costs and expenses	346,522	116.8	230,238	115.1	116,284	50.5		
Loss from operations	(49,848)	(16.8)	(30,164)	(15.1)	(19,684)	65.3		
Interest income	3,053	1.0	267	0.1	2,786	*		
Interest expense	(81)	—	(37)	—	(44)	115.7		
Other income (expense), net	(1,493)	(0.5)	(972)	(0.4)	(521)	53.5		
Loss before income taxes	(48,369)	(16.3)	(30,906)	(15.4)	(17,463)	56.5		
Income tax benefit	5,207	1.8	974	0.4	4,233	*		
Net loss	\$(43,162)	(14.5)	\$(29,932)	(15.0)	\$(13,230)	44.2		

*Not meaningful for comparative purposes.

Our results of operations for the nine month period ended September 30, 2018 includes nine months of operations related to our Short Course Segment, whereas the same period of 2017 includes only three months of such operations as the acquisition of GetSmarter occurred on July 1, 2017.

The following table sets forth the revenue by segment for each of the periods indicated.

	Nine Months Ended		Period-to-Period	
	September 30,		Change	
	2018	2017	Amount	Percentage
	(in thousands)			
Revenue by segment*				
Graduate Program Segment	\$251,487	\$195,748	\$55,739	28.5 %
Short Course Segment	45,187	4,326	40,861	944.5
Total revenue	\$296,674	\$200,074	\$96,600	48.3

* Approximately \$44,000 of intersegment revenues have been excluded from the nine months ended September 30, 2018.

Revenue. Revenue for the nine months ended September 30, 2018 was \$296.7 million, an increase of \$96.6 million, or 48.3%, from \$200.1 million for the same period of 2017. Graduate Program Segment revenue increased by \$55.7 million, or 28.5%. This increase was primarily driven by growth in full course equivalent enrollments of 21,161, or 29.5%, slightly offset by a decrease in the average revenue per full course equivalent enrollment, from \$2,725 to \$2,705. Short Course Segment revenue increased by \$40.9 million, or 944.5%, from \$4.3 million for the same period of 2017. This increase was primarily driven by growth in full course equivalent enrollments of 19,082, or 467.8% and,

to a lesser extent, an increase in the average revenue per full course equivalent enrollment, from \$1,232 to \$1,951. Fluctuations in foreign currency exchange rates from those prevailing in the same period of 2017, did not have a material impact on revenue.

Curriculum and teaching. Curriculum and teaching costs for the nine months ended September 30, 2018 were \$16.7 million, an increase of \$14.9 million, or 830.1%, from \$1.8 million for the same period of 2017. This was primarily due to an increase in the number of short courses taken in our Short Course Segment.

Table of Contents

Servicing and support. Servicing and support costs for the nine months ended September 30, 2018 were \$49.1 million, an increase of \$11.8 million, or 31.6%, from \$37.3 million for the same period of 2017. This was primarily due to an \$8.9 million increase in cash and non-cash compensation and benefit costs, as we increased our headcount in servicing and support by 30% to serve a growing number of students and faculty in existing and new graduate programs and short courses. Additionally, \$1.0 million of the increase related to student immersion costs, while the remaining \$1.9 million of the increase related to higher rent, travel and other servicing and support costs.

Technology and content development. Technology and content development costs for the nine months ended September 30, 2018 were \$45.4 million, an increase of \$12.3 million, or 37.4%, from \$33.1 million for the same period of 2017. The increase was due in part to a \$3.4 million increase in cash and non-cash compensation and benefit costs (net of amounts capitalized for technology and content development), as we increased our headcount in technology and content development by 35% to support the scaling of existing and launching of new graduate programs and short courses. This was also due to a \$5.4 million increase related to higher amortization expense associated with capitalized technology and content development, as well as \$2.2 million of higher hosting and licensing costs. These increases were due to the larger number of courses that have been developed and the continued maintenance of our platform in a cloud environment.

Marketing and sales. Marketing and sales costs for the nine months ended September 30, 2018 were \$172.0 million, an increase of \$58.8 million, or 51.9%, from \$113.2 million for the same period of 2017. The increase was primarily due to higher direct internet marketing costs of \$34.0 million to drive enrollments in our graduate programs and short courses. Additionally, the increase included \$17.2 million of higher cash and non-cash compensation and benefit costs, as we increased our headcount in marketing and sales by 32% to drive enrollment and revenue growth in existing and new graduate programs and short courses. The remaining increase related to \$4.1 million of higher depreciation and amortization, a \$1.7 million increase related to higher rent expense and \$1.9 million related to higher other net cost increases to support our graduate program and short course marketing efforts.

General and administrative. General and administrative costs for the nine months ended September 30, 2018 were \$63.3 million, an increase of \$18.5 million, or 41.3%, from \$44.8 million for the same period of 2017. This was primarily due to a \$16.9 million increase in cash and non-cash compensation and benefit costs, as we increased our headcount in general and administrative by 27% to support our growing business. Other general and administrative costs increased by \$1.6 million due to higher consulting and other professional services, travel costs, depreciation and amortization, rent and other facilities costs, partially offset by reductions in year-over-year costs after the integration of our enterprise resource planning system that was completed in the second quarter of 2017.

Net Interest Income (Expense). In the nine months ended September 30, 2018, we earned net interest income of \$3.0 million, compared to \$0.2 million in the same period of 2017, primarily driven by a higher cash balance resulting from the May 2018 public offering of common stock.

Other Income (Expense), Net. For the nine months ended September 30, 2018, we incurred other expense, net, of \$1.5 million, compared to \$1.0 million in the same period of 2017.

Income Tax Benefit

Our income tax provisions for all periods consist of federal, state and foreign income taxes. The tax provisions for the three and nine months ended September 30, 2018 and 2017 were based on estimated full-year effective tax rates, including the mix of income for the period between higher-taxed and lower-taxed jurisdictions, after giving effect to significant items related specifically to the interim periods, and loss-making entities for which it is not more likely than not that a tax benefit will be realized.

Our effective tax rate was approximately 4% and 6% for the three months ended September 30, 2018 and 2017, respectively. The Company's effective tax rate was approximately 11% and 3% for the nine months ended September 30, 2018 and 2017, respectively. A one-time tax benefit of approximately \$3.0 million related to an asset acquisition of certain third-party technologies is included in our income tax benefit for the nine months ended September 30, 2018. This benefit relates to the reversal of our tax valuation allowance that was no longer needed as a result of establishing a net deferred tax liability. Excluding the one-time tax benefit, our tax benefit of \$0.4 million and \$2.2 million for the three and nine months ended September 30, 2018, respectively, related to losses generated by operations and the amortization of acquired intangibles in our Short Course Segment that are expected to be realized through future reversing taxable temporary differences. We expect to continue to recognize a tax benefit in the future for our Short Course Segment to the extent that this segment continues to generate pre-tax losses while carrying deferred tax liabilities that are in excess of deferred tax assets. To date, we have not been required to pay U.S. federal income taxes because of our current and accumulated net operating losses.

Table of Contents

On December 22, 2017, Staff Accounting Bulletin No. 118 (“SAB 118”) was issued to address the application of U.S. GAAP in situations when a registrant does not have the necessary information available, prepared, or analyzed (including computations) in reasonable detail to complete the accounting for certain income tax effects of the Tax Cuts and Jobs Act of 2017 (“Tax Act”). As of September 30, 2018, we finalized our assessment of the Tax Act, including our determination that no transitional tax is required.

Business Segment Operating Results

We define segment profitability as net income or net loss, as applicable, before net interest income (expense), taxes, depreciation and amortization, foreign currency gains or losses, acquisition-related gains or losses and stock-based compensation expense. Some or all of these items may not be applicable in any given reporting period.

The following table reconciles net loss to total segment profitability:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
	(in thousands)			
Net loss	\$(9,944)	\$(14,739)	\$(43,162)	\$(29,932)
Adjustments:				
Interest income	(1,799)	(18)	(3,053)	(267)
Interest expense	27	36	81	37
Foreign currency loss (gain)	273	(59)	1,493	972
Depreciation and amortization expense	8,599	5,887	23,382	13,318
Income tax benefit	(414)	(974)	(5,207)	(974)
Stock-based compensation expense	7,933	6,147	24,064	15,537
Total adjustments	14,619	11,019	40,760	28,623
Total segment profitability	\$4,675	\$(3,720)	\$(2,402)	\$(1,309)

Three Months Ended September 30, 2018 and 2017

Revenue by segment and segment profitability for the three months ended September 30, 2018 and 2017 were as follows:

	Three Months Ended September 30,		Period-to-Period Change	
	2018	2017	Amount	Percentage
	(in thousands)			
Revenue by segment*				
Graduate Program Segment	\$89,719	\$65,924	\$23,795	36.1 %
Short Course Segment	17,244	4,326	12,918	298.6
Total revenue	\$106,963	\$70,250	\$36,713	52.3
Segment profitability				
Graduate Program Segment	\$5,564	\$(718)	\$6,282	(874.6)
Short Course Segment	(889)	(3,002)	2,113	(70.4)
Total segment profitability	\$4,675	\$(3,720)	\$8,395	(225.7)

* Approximately \$44,000 of intersegment revenues have been excluded from the three months ended September 30, 2018.

Segment profitability in our Graduate Program Segment for the three months ended September 30, 2018 was \$5.6 million, an increase of \$6.3 million, or 874.6%, from \$(0.7) million for the same period of 2017. The primary factor favorably impacting segment profitability in this segment was the year-over-year growth in revenue. Additionally, we experienced a decrease in annual incentive compensation cost accruals and a decline in professional fees following the implementation of an enterprise resource planning system that was largely completed in 2017. We expect to increase investment in the development, marketing and support of newer and newly launching programs in this segment. Based on timing differences between the addition of costs related to the increased investment and the related recognition of revenue, we expect that there will be significant variability in segment profitability in this segment between periods.

Table of Contents

Segment profitability in our Short Course Segment for the three months ended September 30, 2018 was \$(0.9) million, an increase of \$2.1 million, or 70.4%, from \$(3.0) million for the same period of 2017. The primary factor favorably impacting segment profitability in this segment was the year-over-year growth in revenue. There were also changes in relative expense levels and expense timing in this period of rapid growth for the Short Course Segment, year-over-year and quarter-over-quarter. Therefore, changes in segment profitability do not necessarily represent a business trend. Changes in segment profitability are highly dependent upon the timing of new course launches and new course presentations. We expect to increase investment in the development, marketing and support of newer and newly launching courses in this segment. Based on timing differences between the addition of costs related to the increased investment and the related recognition of revenue, we expect that there will be significant variability in segment profitability in this segment between periods.

Nine Months Ended September 30, 2018 and 2017

Revenue by segment and segment profitability for the nine months ended September 30, 2018 and 2017 were as follows:

	Nine Months Ended		Period-to-Period		
	September 30, 2018	2017	Change Amount	Percentage	
	(in thousands)				
Revenue by segment*					
Graduate Program Segment	\$251,487	\$195,748	\$55,739	28.5	%
Short Course Segment	45,187	4,326	40,861	944.5	
Total revenue	\$296,674	\$200,074	\$96,600	48.3	
Segment profitability					
Graduate Program Segment	\$(615)	\$1,693	\$(2,308)	(136.4)	
Short Course Segment	(1,787)	(3,002)	1,215	(40.5)	
Total segment profitability	\$(2,402)	\$(1,309)	\$(1,093)	83.5	

* Approximately \$44,000 of intersegment revenues have been excluded from the nine months ended September 30, 2018.

Segment profitability for the nine month period ended September 30, 2018 includes nine months of operations related to our Short Course Segment, whereas the same period of 2017 includes only three months of such operations as the acquisition of GetSmarter occurred on July 1, 2017.

Segment profitability in our Graduate Program Segment for the nine months ended September 30, 2018 was \$(0.6) million, a decrease of \$2.3 million, or 136%, from \$1.7 million for the same period of 2017. The period-over-period decrease in segment profitability in this segment was primarily due to cost growth outpacing revenue growth, particularly in marketing spend and marketing and program staffing, during the first nine months of 2018. We have been scaling operations to prepare for future launches of an increasing number of programs in 2018 and 2019 as compared to 2017. We expect to increase investment in the development, marketing and support of newer and newly launching programs in this segment. Based on timing differences between the addition of costs related to the increased investment and the related recognition of revenue, we expect that there will be significant variability in segment profitability in this segment between periods.

Segment profitability in our Short Course Segment for the nine months ended September 30, 2018 was \$(1.8) million, an increase of \$1.2 million, or 41%, from \$(3.0) million for the same period of 2017. The primary factor favorably

impacting segment profitability in this segment was year-over-year growth in revenue. There were also changes in relative expense levels and expense timing in this period of rapid growth for the Short Course Segment, year-over-year and quarter-over-quarter. Therefore, changes in segment profitability do not necessarily represent a business trend. Changes in segment profitability are highly dependent upon the timing of new course launches and new course presentations. We expect to increase investment in the development, marketing and support of newer and newly launching courses in this segment. Based on timing differences between the addition of costs related to the increased investment and the related recognition of revenue, we expect that there will be significant variability in segment profitability in this segment between periods.

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, and

Table of Contents

revenue and the components of loss from operations in the section above entitled “Our Business Model and Components of Operating Results,” we utilize full course equivalent enrollments as a key metric to evaluate the success of our growth strategy.

Full Course Equivalent Enrollments in Our University Clients’ Offerings

We measure full course equivalent enrollments for each of the courses offered during a particular period by taking the number of students enrolled in that course and multiplying it by the percentage of the course completed during that period. We add the full course equivalent enrollments for each course within each segment to calculate the total full course equivalent enrollments per segment. This metric allows us to consistently view period over period changes in enrollments by accounting for the fact that many courses we enable 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 during a period in each of our operating segments. This number is derived by dividing the total revenue for a period for each of our operating segments by the number of full course equivalent enrollments within the applicable segment during that same period. This amount may vary from period to period depending on the academic calendars of our university clients, the relative growth rates of our graduate programs and short courses, as applicable, and varying tuition levels, among other factors.

The following table sets forth the full course equivalent enrollments and average revenue per full course equivalent enrollment in our Graduate Program Segment and Short Course Segment for the periods presented.

	Three Months		Nine Months	
	Ended		Ended	
	September 30,		September 30,	
	2018	2017	2018	2017*
Graduate Program Segment				
Full course equivalent enrollments	32,665	24,062	92,983	71,822
Average revenue per full course equivalent enrollment	\$2,747	\$2,740	\$2,705	\$2,725
Short Course Segment				
Full course equivalent enrollments	8,937	4,079	23,161	4,079
Average revenue per full course equivalent enrollment**	\$1,930	\$1,232	\$1,951	\$1,232

We acquired GetSmarter on July 1, 2017 and their results of operations are included in our consolidated financial *results effective with the third quarter of 2017. As such, the full course equivalent enrollment metrics of our Short Course Segment are measured only for the third quarter of 2017.

The calculation of the Short Course Segment’s average revenue per full course equivalent enrollment includes \$0.7 **million of revenue that was excluded from the results of operations for the third quarter of 2017, due to an adjustment recorded as part of the valuation of GetSmarter.

Of the increase in graduate program full course equivalent enrollments for the three months ended September 30, 2018, 3,975 or 46.2% were attributable to graduate programs launched during the preceding 12 months. Of the increase in graduate program full course equivalent enrollments for the nine months ended September 30, 2018, 7,766 or 36.7% were attributable to graduate programs launched during the preceding 12 months.

Adjusted EBITDA

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

Adjusted EBITDA is not a measure calculated in accordance with U.S. GAAP, and should not be considered as an alternative to any measure of financial performance calculated and presented in accordance with U.S. GAAP. In addition, adjusted EBITDA may not be comparable to similarly titled measures of other companies because other companies may not calculate adjusted

Table of Contents

EBITDA in the same manner as we do. We prepare adjusted EBITDA to eliminate the impact of stock-based compensation expense, which we do not consider indicative of our core operating performance.

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

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

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

adjusted EBITDA does not reflect acquisition related gains or losses such as, but not limited to, post-acquisition changes in the value of contingent consideration reflected in operations;

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

adjusted EBITDA does not reflect interest or tax payments that may represent a reduction in cash available to us; and other companies, including companies in our industry, may calculate adjusted EBITDA differently, which reduces its usefulness as a comparative measure.

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

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2018	2017	2018	2017
	(in thousands)			
Net loss	\$ (9,944)	\$ (14,739)	\$ (43,162)	\$ (29,932)
Adjustments:				
Interest income	(1,799)	(18)	(3,053)	(267)
Interest expense	27	36	81	37
Foreign currency (gain) loss	273	(59)	1,493	972
Depreciation and amortization expense	8,599	5,887	23,382	13,318
Income tax benefit	(414)	(974)	(5,207)	(974)
Stock-based compensation expense	7,933	6,147	24,064	15,537
Total adjustments	14,619	11,019	40,760	28,623
Adjusted EBITDA (loss)	\$4,675	\$ (3,720)	\$ (2,402)	\$ (1,309)

Capital Resources and Liquidity

Capital Expenditures

During the nine months ended September 30, 2018, we had capital asset additions of \$70.7 million, which were comprised of \$56.0 million in capitalized technology and content development, \$6.0 million of other property and equipment, \$5.8 million of trade and domain names, and \$2.9 million of leasehold improvements. The \$70.7 million of capital asset additions consisted of \$59.7 million in cash capital expenditures and \$6.1 million of non-cash capital expenditures, primarily related to the acquisition of certain long-lived assets for which we have an accrued liability. Due to extended payment terms associated with the timing of cash capital expenditures made more than 90 days after the date of purchase, an additional \$4.9 million was classified as cash flows from financing activities in the condensed

consolidated statement of cash flows for the nine months ended September 30, 2018. For the full year of 2018, we expect new capital asset additions of approximately \$82 to \$86 million, of which approximately \$2 to \$3 million will be funded by landlord leasehold improvement allowances, with \$2 million related to the acquisition of certain long-lived assets for which we are not obligated to make a payment until 2019 and \$3 million related to a one-time tax benefit related to the acquisition of certain long-lived assets.

Table of Contents

Sources of Liquidity

Lines of Credit

In June 2017, we amended our credit agreement with Comerica Bank (“Comerica”) for a \$25.0 million revolving line of credit pursuant to which, among other things, Comerica consented to our acquisition of GetSmarter and our formation of certain subsidiaries in connection therewith, and we extended the maturity date through July 31, 2017. Effective in the third quarter of 2018, we further amended our revolving line of credit agreement to extend the maturity date through December 31, 2018. No amounts were outstanding under this credit agreement as of September 30, 2018 or December 31, 2017.

Certain of our operating lease agreements entered into prior to September 30, 2018 require security deposits in the form of cash or an unconditional, irrevocable letter of credit. As of September 30, 2018, we had entered into standby letters of credit totaling \$15.0 million, as security deposits for the applicable leased facilities and in connection with government grants. These letters of credit reduced the aggregate amount we may borrow under its revolving line of credit to \$10.0 million.

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

Borrowings under the line of credit are collateralized by substantially all of our assets. The availability of borrowings under this credit line is subject to our compliance with reporting and financial covenants, including, among other things, that we achieve specified minimum three-month trailing revenue levels during the term of the agreement and specified minimum six-month trailing profitability levels for some of our graduate programs, measured quarterly. In addition, we are required to maintain a minimum adjusted quick ratio, which measures our short-term liquidity, of at least 1.10 to 1.00. As of September 30, 2018 and December 31, 2017, our adjusted quick ratios were 10.79 and 5.44, respectively.

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

Our \$1.9 million revolving debt facilities related to the Short Course Segment expired and were not renewed as of March 31, 2018.

Government Grants

In June 2017, we entered into a total of two conditional loan agreements with Prince George's County, Maryland and the State of Maryland for an aggregate amount of \$3.5 million, each bearing an interest rate of 3% per annum. These agreements are conditional loan obligations that may be forgiven provided that we attain certain conditions related to employment levels at our Lanham, Maryland headquarters. The loan with the State of Maryland has a maturity date of December 31, 2026, and the loan with Prince George's County, Maryland has a maturity date of June 22, 2027. The interest expense related to these loans for the three and nine months ended September 30, 2018 and 2017 is immaterial.

Public Offering of Common Stock

On May 22, 2018 we sold 3,833,334 shares of our common stock to the public, including 500,000 shares sold pursuant to the underwriters' over-allotment option. We received net proceeds of \$330.8 million, which we intend to use for working capital and other general corporate purposes, including expenditures for graduate program and short course marketing, technology and content development, in connection with new graduate program and short course launches and growing existing graduate programs and short courses as well as the strategic acquisitions of, or investment in, complementary products, technologies, solutions or businesses.

Working Capital

32

Table of Contents

Our cash as of September 30, 2018 was held for working capital purposes. Our working capital as of September 30, 2018 and December 31, 2017 was \$447.4 million and \$190.1 million, respectively. We do not enter into investments for trading or speculative purposes. We invest any cash in excess of our immediate requirements in investments designed to preserve the principal balance and provide liquidity. Accordingly, our cash is invested primarily in demand deposit accounts that are currently providing only a minimal return.

Cash Flows

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

	Nine Months Ended		Period-to-Period	
	September 30, 2018	2017	Change Amount	Percentage
	(in thousands)			
Cash (used in) provided by:				
Operating activities	\$(26,043)	\$(26,079)	\$36	(0.1)%
Investing activities	(85,015)	(134,409)	49,394	(36.7)
Financing activities	330,822	195,241	135,581	69.4
Effect of exchange rate changes on cash	(908)	(1,049)	141	(13.4)
Net increase in cash and cash equivalents	\$218,856	\$33,704	\$185,152	549.3

Operating Activities

Cash used in operating activities for the nine months ended September 30, 2018 was \$26.0 million, a decrease of \$36,000 or 0.1% from \$26.1 million for the same period of 2017. This was primarily due to a \$43.2 million net loss and a \$40.9 million decrease in cash due to net increases in current assets. These decreases in cash were partially offset by \$24.1 million in stock-based compensation expense, \$23.4 million in depreciation and amortization expense, a \$9.1 million increase in current liabilities and other net cash inflows of \$1.5 million.

Investing Activities

Cash used in investing activities for the nine months ended September 30, 2018 was \$85.0 million, a decrease of \$49.4 million or 36.7% from \$134.4 million for the same period of 2017. This was primarily due to the July 1, 2017 acquisition of GetSmarter for \$97.1 million and a \$12.9 million decrease in purchases of property, plant and equipment as we moved into new facilities in the prior year. These decreases in outflows were partially offset by an increase of \$35.3 million in amortizable intangible assets to support a greater number of launched graduate programs and short courses. The increase in amortizable intangible assets included an increase of \$17.3 million in acquisitions of technology to be integrated into our platform, including \$9.0 million related to the purchase of WeWork's intangible assets. Additionally offsetting these decreases in outflows was a \$25.0 million outflow related to a short-term investment in a certificate of deposit.

Financing Activities

Cash provided by financing activities for the nine months ended September 30, 2018 was \$330.8 million, an increase of \$135.6 million from \$195.2 million for the same period of 2017. This was primarily due to \$330.8 million in proceeds received from our public offering of common stock.

Other

We do not have any off-balance sheet arrangements, as defined in Item 303(a)(4)(ii) of Regulation S-K, such as the use of unconsolidated subsidiaries, structured finance, special purpose entities or variable interest entities.

Table of Contents

Critical Accounting Policies

Revenue Recognition, Accounts Receivable and Allowance for Doubtful Accounts

On January 1, 2018, we adopted ASU No. 2014-09, Revenue from Contracts with Customers (Topic 606) and the related amendments using the modified retrospective transition method and concluded that doing so did not have a material impact on the amount and timing of either our revenue or costs. As part of our assessment, we completed reviews of our contracts and evaluated our costs, including costs of obtaining contracts with our university clients and costs associated with content development. Certain of these contract and content costs will be capitalized under the new standard. The adoption of ASU 2014-09 did not have a material impact as of January 1, 2018, and no cumulative adjustment was recorded. Further, the amounts reported as of September 30, 2018 on our condensed consolidated balance sheets and the results of operations for the three and nine months ended September 30, 2018 reported on the condensed consolidated statements of operations and comprehensive loss would not have been materially different than under legacy U.S. GAAP (i.e., Topic 605).

We generate substantially all of our revenue from contractual arrangements with either our university clients or students to provide a comprehensive platform of tightly integrated technology and technology-enabled services that support our graduate programs and short courses.

Performance Obligations

A performance obligation is a promise in a contract to transfer a distinct good or service to the customer. A contract's transaction price is allocated to each distinct performance obligation and recognized as revenue when, or as, the performance obligation is satisfied.

Our Graduate Program Segment derives revenue primarily from contractually specified percentages of the amounts our university clients receive from their students in 2U-enabled graduate programs for tuition and fees, less credit card fees and other specified charges we have agreed to exclude in certain university client contracts. Our contracts with university clients in this segment have 10 to 15 year initial terms and have a single performance obligation, as the promises to provide a platform of tightly integrated technology and services university clients need to attract, enroll, educate and support students are not distinct within the context of the contracts. The single performance obligation is delivered as the university clients receive and consume benefits, which occurs ratably over a series of academic terms. The fees received from university clients over the term of the arrangement are variable in nature in that they are dependent upon the number of students that are enrolled in the program within each academic term. The fees are allocated to and are recognized ratably over the related academic term, defined as the period beginning on the first day of classes through the last. A refund allowance is established for our share of tuition and fees ultimately uncollected by university clients.

Our Short Course Segment derives revenue directly from contracts with students for the tuition and fees paid to enroll in and progress through our short courses which run between six and 16 weeks. Our contracts with students in this segment have multiple performance obligations as the delivery of the short course and student support services are each considered distinct performance obligations. These performance obligations are each satisfied ratably over the same short course presentation period, which is defined as the period beginning on the first day of the course through the last. We recognize the gross proceeds received from our students and share contractually specified percentages with our university clients, for providing short course content and certification, in the form of a royalty recognized as curriculum and teaching costs on our condensed consolidated statements of operations and comprehensive loss. Our contracts with university clients in this segment are typically shorter and less restrictive than our contracts with university clients in our Graduate Program Segment.

We do not disclose the value of unsatisfied performance obligations for our Graduate Program Segment because the variable consideration is allocated entirely to a wholly unsatisfied promise to transfer a service that forms part of a single performance obligation. We do not disclose the value of unsatisfied performance obligations for our Short Course Segment because the performance obligation is part of a contract that has an original duration of less than one year.

Contract Acquisition Costs

We pay commissions to certain of our employees to obtain contracts with university clients in our Graduate Program Segment. These costs are capitalized and recorded on a contract-by-contract basis and amortized using the straight-line method over the expected life, which is generally the length of the contract.

With respect to contract acquisition costs in our Short Course Segment, we have elected to apply the practical expedient in ASC Topic 606 to expense these costs as incurred, as the terms of contracts with students in this segment are less than one year.

Table of Contents

Payments to University Clients

Pursuant to certain of our contracts in the Graduate Program Segment, we have made, or are obligated to make, payments to university clients in exchange for contract extensions and various marketing and other rights. Generally, these amounts are capitalized and amortized as contra revenue over the life of the contract, commencing on the later of when payment is due or when contract revenue recognition begins.

Accounts Receivable, Contract Assets and Liabilities

Balance sheet items related to contracts consist of accounts receivable, net and deferred revenue on our condensed consolidated balance sheets. Included in accounts receivable, net are trade accounts receivable, which are comprised of billed and unbilled revenue. Accounts receivable, net is stated at net realizable value, and we utilize the allowance method to provide for doubtful accounts based on management's evaluation of the collectability of the amounts due. Our estimates are reviewed and revised periodically based on historical collection experience and a review of the current status of accounts receivable, net. Historically, actual write-offs for uncollectible accounts have not significantly differed from prior estimates. We recognize unbilled revenue when revenue recognition occurs in advance of billings. Unbilled revenue is recognized in our Graduate Program Segment because billings to university clients does not occur until after the academic term has commenced and final enrollment information is available. Our unbilled revenue represents contract assets.

Deferred revenue as of each balance sheet date represents the excess of amounts billed or received as compared to amounts recognized in revenue on our condensed consolidated statements of operations and comprehensive loss as of the end of the reporting period, and such amounts are reflected as a current liability on our condensed consolidated balance sheets. We generally receive payments for our share of tuition and fees from graduate program university clients early in each academic term and from short course students, either in full upon registration for the course or in full before the end of the course based on a payment plan, prior to completion of the service period. These payments are recorded as deferred revenue until the services are delivered or until our obligations are otherwise met, at which time revenue is recognized.

Goodwill

Goodwill is the excess of purchase price over the fair value of identified net assets of the business acquired. Our goodwill balance was established in connection with our acquisition of GetSmarter in 2017. We will review goodwill at least annually, as of October 1, for possible impairment. Between annual tests, goodwill is reviewed for possible impairment if an event occurs or circumstances change that would more likely than not reduce the fair value of the reporting unit below its carrying value. We will test our goodwill at the reporting unit level, which is an operating segment or one level below an operating segment. We initially will assess qualitative factors to determine if it is necessary to perform the two-step goodwill impairment review. We will review our goodwill for impairment using the two-step process if we decide to bypass the qualitative assessment or determine that it is more likely than not that the fair value of a reporting unit is less than its carrying value based on our qualitative assessment. Upon the completion of the two-step process, we may be required to recognize an impairment based on the difference between the carrying value and the fair value of the goodwill recorded.

Internally-Developed Intangible Assets

Capitalized Technology

Capitalized technology includes certain purchased software and technology licenses, direct third-party costs, and internal payroll and payroll-related costs used in the creation of our internal-use 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 our 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 we expect to benefit from the use of that software. Once the software is placed in service, these costs are amortized on the straight-line method over the estimated useful life of the software, which is generally three to five years.

Table of Contents

Capitalized Content Development

We develop content for each offering on a course-by-course basis in conjunction with the faculty for each graduate program and short course. University clients and their faculty generally provide materials used for the course in an on-campus setting, including curricula, case studies and other reading materials, and presentations. We are responsible for the conversion of the materials into a format suitable for delivery through our online learning platform, including all expenses associated with this effort. With regard to the Graduate Program Segment, the development of content is part of our single performance obligation and is considered a contract fulfillment cost.

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, we capitalize internal payroll and payroll-related costs incurred to create and produce videos and other digital content utilized in the university clients' offerings for delivery via our online learning platform. Capitalization ends when content has been fully developed by both us and the university client, at which time amortization of the capitalized content development costs begin. The capitalized costs for each offering are recorded on a course-by-course basis and included in capitalized content costs in amortizable intangible assets, net on our condensed consolidated balance sheets. These costs are amortized using the straight-line method over the estimated useful life of the respective course, which is generally four to five years. The estimated useful life corresponds with the planned curriculum refresh rate. This refresh rate is consistent with expected curriculum refresh rates as cited by faculty members for similar on-campus offerings. It is reasonably possible that developed content could be refreshed before the estimated useful lives are complete or be expensed immediately in the event that the development of a course is discontinued prior to launch.

Evaluation of Long-Lived Assets

We review long-lived assets, which consist of property and equipment, capitalized technology costs, capitalized content development costs and acquired finite-lived intangible assets, for impairment whenever events or changes in circumstances indicate the carrying value of an asset may not be recoverable. Recoverability of a long-lived asset is measured by a comparison of the carrying value of an asset or asset group to the future undiscounted net cash flows expected to be generated by that asset or asset group. If such assets are not recoverable, the impairment to be recognized is measured by the amount by which the carrying value of an asset exceeds the estimated fair value (discounted cash flow) of the asset or asset group. In order to assess the recoverability of the capitalized technology and content development costs, the costs are grouped by degree vertical, which is the lowest level of independent cash flows. Our impairment analysis is based upon cumulative results and forecasted performance. The actual results could vary from our forecasts, especially in relation to recently launched programs.

Stock-Based Compensation

We have issued three types of stock-based awards under our stock plans: stock options, restricted stock units and stock awards. Stock option awards granted to employees, directors and independent contractors are measured at fair value at each grant date. We rely on the Black-Scholes option pricing model for estimating the fair value of stock options granted, and expected volatility is based on the historical volatilities of our common stock. For awards subject to service-based vesting conditions, we recognize compensation expense on a straight-line basis over the requisite service period of the award. Prior to January 1, 2017, we adjusted stock-based compensation expense for estimated forfeitures. Beginning on January 1, 2017, we account for forfeitures (and the impact on stock-based compensation expense) as they occur. Stock options subject to service-based vesting generally vest at various times from the date of the grant, with most stock options vesting in tranches, generally over a period of four years. Restricted stock units subject to service-based vesting generally vest 25% on each anniversary of the grant date over four years.

Income Tax (Expense) Benefit

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. Under this method, the deferred tax assets and liabilities are determined based on the differences between the financial statement and tax bases of the assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to reverse. The effect of a change in tax rates on the deferred tax assets and liabilities is recognized in earnings in the period when the new rate is enacted. Deferred tax assets are subject to periodic recoverability assessments. Valuation allowances are established, when necessary, to reduce deferred tax assets to the amount that more likely than not will be realized. We consider all positive and negative evidence relating to the realization of the deferred tax assets in assessing the need for a valuation allowance. We currently maintain a full valuation allowance against our deferred tax assets in the U.S. and certain entities in the foreign jurisdictions.

Table of Contents

We record a liability for unrecognized tax benefits resulting from uncertain tax positions taken or expected to be taken in a tax return. We account for uncertainty in income taxes using a two-step approach for evaluating tax positions. Step one, recognition, occurs when we conclude that a tax position, based solely on its technical merits, is more likely than not to be sustained upon examination. Step two, measurement, determines the amount of benefit that is more likely than not to be realized upon ultimate settlement with a taxing authority that has full knowledge of all relevant information. De-recognition of a tax position that was previously recognized would occur if we subsequently determine that a tax position no longer meets the more likely than not threshold of being sustained. We recognize interest and penalties, if any, related to unrecognized tax benefits as income tax expense on our consolidated statements of operations.

Recent Accounting Pronouncements

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

Table of Contents

Item 3. Quantitative and Qualitative Disclosures About Market Risk

There have been no material changes to market risk from the information provided in Part II, Item 7A of our Annual Report on Form 10-K, filed with the SEC on February 27, 2018, except for the changes in foreign currency exchange risk resulting from our acquisition of GetSmarter, as described below.

Foreign Currency Exchange Risk

Prior to July 1, 2017, we did not have significant foreign currency exchange risk. Beginning in the third quarter of 2017, with the acquisition of GetSmarter, we now transact material business in foreign currencies and are exposed to risks resulting from fluctuations in foreign currency exchange rates. Our primary exposures are related to non-U.S. dollar denominated revenue and operating expenses in South Africa and the United Kingdom. Accounts relating to foreign operations are translated into U.S. dollars using prevailing exchange rates at the relevant period end. As a result, we would experience increased revenue and operating expenses in our non-U.S. operations if there were a decline in the value of the U.S. dollar relative to these foreign currencies. Conversely, we would experience decreased revenue and operating expenses in our non-U.S. operations if there were an increase in the value of the U.S. dollar relative to these foreign currencies. Translation adjustments are included as a separate component of stockholders' equity.

For the nine months ended September 30, 2018 and 2017, our foreign currency translation adjustment was a loss of \$12.3 million and \$3.6 million, respectively.

For the three months ended September 30, 2018 and 2017, we recognized a foreign currency exchange loss of \$0.3 million and \$0.1 million, respectively, included on our consolidated statements of operations and comprehensive loss. For the nine months ended September 30, 2018 and 2017, we recognized a foreign currency exchange loss of \$1.5 million and \$1.0 million, respectively, included on our consolidated statements of operations and comprehensive loss.

The foreign exchange rate volatility of the trailing 12 months ending September 30, 2018 was 10.6% and 5.1% for the South African rand and British pound, respectively. A 10% fluctuation of foreign currency exchange rates would have had an immaterial effect on our results of operations and cash flows for all periods presented. The fluctuations of currencies in which we conduct business can both increase and decrease our overall revenue and expenses for any given fiscal period. Such volatility, even when it increases our revenues or decreases our expenses, impacts our ability to accurately predict our future results and earnings.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our reports under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure based on the definition of "disclosure controls and procedures" as promulgated under the Exchange Act and the rules and regulations thereunder. In designing and evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on

this evaluation, management concluded that our disclosure controls and procedures were effective at a reasonable assurance level as of September 30, 2018.

Changes in Internal Control Over Financial Reporting

We made no changes in internal control over financial reporting during the third quarter of 2018 that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting, other than changes in control to integrate the business we acquired in the GetSmarter acquisition.

Table of Contents

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

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

Item 1A. Risk Factors

The risks described in Part I, Item 1A “Risk Factors” in our Annual Report on Form 10-K for the year ended December 31, 2017, which was filed with the SEC on February 27, 2018, remain current in all material respects. These risks do not identify all risks that we face. Our operations could also be affected by factors that are not presently known to us or that we currently consider to be immaterial to our operations.

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

(a) Sales of Unregistered Securities

None.

(b) Use of Proceeds from Public Offerings of Common Stock

None.

(c) Purchases of Equity Securities by the Issuer and Affiliated Purchasers

None.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Mine Safety Disclosures

None.

Item 5. Other Information

None.

Table of Contents

Item 6. Exhibit Number	Exhibits Description	Form	File No.	Exhibit Number	Filing Date	Filed Herewith
<u>3.1</u>	Amended and Restated Certificate of Incorporation of the Registrant.	8-K	001-36376	3.1	April 4, 2014	
<u>3.2</u>	Amended and Restated Bylaws of the Registrant.	8-K	001-36376	3.2	April 4, 2014	
<u>31.1</u>	Certification of Chief Executive Officer of 2U, Inc. pursuant to Exchange Act Rule 13a-14(a)/15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.					X
<u>31.2</u>	Certification of Chief Financial Officer of 2U, Inc. pursuant to Exchange Act Rule 13a-14(a)/15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.					X
<u>32.1</u>	Certification of Chief Executive Officer of 2U, Inc. in accordance with 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.					X
<u>32.2</u>	Certification of Chief Financial Officer of 2U, Inc. in accordance with 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.					X
101.INS	XBRL Instance Document.					X
101.SCH	XBRL Taxonomy Extension Schema Document.					X
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document.					X
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document.					X
101.LAB	XBRL Taxonomy Extension Label Linkbase Document.					X
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document.					X

Table of Contents

SIGNATURES

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

2U, Inc.

November 5, 2018 By: /s/ Christopher J. Paucek
Christopher J. Paucek
Chief Executive Officer

November 5, 2018 By: /s/ Catherine A. Graham
Catherine A. Graham
Chief Financial Officer