

Benefitfocus, Inc.  
Form 10-Q  
November 03, 2017

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, 2017

or

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

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

Commission File Number: 001-36061

Benefitfocus, Inc.

(Exact name of registrant as specified in its charter)

Delaware 46-2346314  
(State or other jurisdiction of (I.R.S. Employer  
incorporation or organization) Identification No.)

100 Benefitfocus Way

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Charleston, South Carolina 29492

(Address of principal executive offices and zip code)

(843) 849-7476

(Registrant's telephone number, including area code)

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

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer (Do not check if a smaller reporting company) 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 27, 2017, there were approximately 31,273,234 shares of the registrant's common stock outstanding.

Benefitfocus, Inc.

Form 10-Q

For the Quarterly Period Ended September 30, 2017

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## PART I. FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS

Benefitfocus, Inc.

Unaudited Consolidated Balance Sheets

(in thousands, except share and per share data)

	As of	As of
	September	December
	30,	31,
	2017	2016
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$54,573	\$56,853
Marketable securities	–	2,007
Accounts receivable, net	33,332	28,340
Accounts receivable, related party, net	–	4,626
Prepaid expenses and other current assets	5,417	4,449
Total current assets	93,322	96,275
Property and equipment, net	75,035	80,518
Intangible assets, net	215	408
Goodwill	1,634	1,634
Other non-current assets	1,014	1,575
Total assets	\$171,220	\$180,410
<b>Liabilities and stockholders' deficit</b>		
Current liabilities:		
Accounts payable	\$1,401	\$5,829
Accrued expenses	8,979	10,867
Accrued compensation and benefits	11,926	17,347
Deferred revenue, current portion	32,649	35,426
Revolving line of credit, current portion	28,000	20,000
Financing and capital lease obligations, current portion	3,395	2,604
Total current liabilities	86,350	92,073
Deferred revenue, net of current portion	31,149	40,412
Revolving line of credit, net of current portion	32,246	20,246
Financing and capital lease obligations, net of current portion	56,132	57,934
Other non-current liabilities	2,304	3,056
Total liabilities	208,181	213,721
Commitments and contingencies		
Stockholders' deficit:		
Preferred stock, par value \$0.001, 5,000,000 shares authorized,	–	–

no shares issued and outstanding at September 30, 2017

and December 31, 2016		
Common stock, par value \$0.001, 50,000,000 shares authorized,		
31,195,653 and 30,429,014 shares issued and outstanding		
at September 30, 2017 and December 31, 2016, respectively	31	30
Additional paid-in capital	350,667	335,059
Accumulated deficit	(387,659)	(368,400)
Total stockholders' deficit	(36,961 )	(33,311 )
Total liabilities and stockholders' deficit	\$171,220	\$180,410

The accompanying notes are an integral part of the Unaudited Consolidated Financial Statements.

Benefitfocus, Inc.

## Unaudited Consolidated Statements of Operations and Comprehensive Loss

(in thousands, except share and per share data)

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2017	2016	2017	2016
Revenue	\$62,453	\$58,022	\$189,972	\$170,688
Cost of revenue	30,467	29,112	90,896	88,159
Gross profit	31,986	28,910	99,076	82,529
Operating expenses:				
Sales and marketing	16,180	13,607	51,103	41,942
Research and development	12,568	14,081	37,222	43,276
General and administrative	6,853	7,746	20,487	24,415
Total operating expenses	35,601	35,434	108,812	109,633
Loss from operations	(3,615 )	(6,524 )	(9,736 )	(27,104 )
Other income (expense):				
Interest income	55	25	129	117
Interest expense on building lease financing obligations	(1,864 )	(1,704 )	(5,585 )	(5,130 )
Interest expense on other borrowings	(1,254 )	(262 )	(3,526 )	(691 )
Other income (expense)	9	(133 )	(140 )	(136 )
Total other expense, net	(3,054 )	(2,074 )	(9,122 )	(5,840 )
Loss before income taxes	(6,669 )	(8,598 )	(18,858 )	(32,944 )
Income tax expense	5	5	10	15
Net loss	\$(6,674 )	\$(8,603 )	\$(18,868 )	\$(32,959 )
Comprehensive loss	\$(6,674 )	\$(8,603 )	\$(18,868 )	\$(32,959 )
Net loss per common share:				
Basic and diluted	\$(0.21 )	\$(0.29 )	\$(0.61 )	\$(1.12 )
Weighted-average common shares outstanding:				
Basic and diluted	31,181,141	29,651,230	30,974,116	29,442,023

The accompanying notes are an integral part of the Unaudited Consolidated Financial Statements.

Benefitfocus, Inc.

## Unaudited Consolidated Statement of Changes in Stockholders' Deficit

(in thousands, except share and per share data)

	Common Stock, \$0.001 Par Value Shares	Par Value	Additional Paid-in Capital	Accumulated Deficit	Total Stockholders' Deficit
Balance, December 31, 2016	30,429,014	\$ 30	\$ 335,059	\$ (368,400 )	\$ (33,311 )
Cumulative effect adjustment from adoption of new accounting standard	—	—	391	(391 )	—
Exercise of stock options	445,185	1	3,314	—	3,315
Issuance of common stock upon vesting of restricted stock units	313,285	—	—	—	—
Issuance of common stock under Employee Stock Purchase Plan, or ESPP	8,169	—	257	—	257
Stock-based compensation expense	—	—	11,646	—	11,646
Net loss	—	—	—	(18,868 )	(18,868 )
Balance, September 30, 2017	31,195,653	\$ 31	\$ 350,667	\$ (387,659 )	\$ (36,961 )

The accompanying notes are an integral part of the Unaudited Consolidated Financial Statements.

Benefitfocus, Inc.

## Unaudited Consolidated Statements of Cash Flows

(in thousands)

	Nine Months Ended	
	September 30, 2017	2016
Cash flows from operating activities		
Net loss	\$ (18,868 )	\$ (32,959 )
Adjustments to reconcile net loss to net cash and cash equivalents used in operating activities:		
Depreciation and amortization	11,848	9,619
Stock-based compensation expense	11,646	13,610
Interest accrual on financing obligation	5,623	5,130
Loss on disposal or impairment of property and equipment	157	140
Provision for doubtful accounts	142	287
Changes in operating assets and liabilities:		
Accounts receivable, net	(508 )	(1,655 )
Accrued interest on short-term investments	7	217
Prepaid expenses and other current assets	(968 )	465
Other non-current assets	561	142
Accounts payable	(4,343 )	(3,844 )
Accrued expenses	(2,152 )	4,726
Accrued compensation and benefits	(5,422 )	(3,460 )
Deferred revenue	(12,040 )	(13,819 )



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Other non-current liabilities	(751 )	538
Net cash and cash equivalents used in operating activities	(15,068 )	(20,863 )
Cash flows from investing activities		
Purchases of short-term investments held to maturity	–	(2,004 )
Proceeds from maturity of short-term investments held to maturity	2,000	37,725
Purchases of property and equipment	(6,151 )	(10,861 )
Net cash and cash equivalents (used in) provided by investing activities	(4,151 )	24,860
Cash flows from financing activities		
Draws on revolving line of credit	81,000	64,000
Payments on revolving line of credit	(61,000 )	(59,000 )
Proceeds from exercises of stock options and ESPP	3,572	2,118
Remittance of taxes upon vesting of restricted stock units	–	(202 )
Payments on financing and capital lease obligations	(6,633 )	(8,187 )
Net cash and cash equivalents provided by (used in) financing activities	16,939	(1,271 )
Net (decrease) increase in cash and cash equivalents	(2,280 )	2,726
Cash and cash equivalents, beginning of period	56,853	48,074
Cash and cash equivalents, end of period	\$ 54,573	\$ 50,800

Supplemental  
disclosure of  
non-cash investing  
and financing  
activities

Property and  
equipment purchases  
in accounts payable  
and accrued expenses

\$ 878

\$ 856

Property and  
equipment purchased  
with financing and  
capital lease  
obligations

\$ —

\$ 2,233

Post contract support  
purchased with  
financing obligations

\$ —

\$ 1,048

The accompanying notes are an integral part of the Unaudited Consolidated Financial Statements.

BENEFITFOCUS, INC.

## NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

(in thousands, except share and per share data)

### 1. Organization and Description of Business

Benefitfocus, Inc. (the “Company”) provides a leading cloud-based benefits management platform for consumers, employers, insurance carriers and brokers under a software-as-a-service (“SaaS”) model. The financial statements of the Company include the financial position and operations of its wholly owned subsidiaries, Benefitfocus.com, Inc. and BenefitStore, Inc.

### 2. Summary of Significant Accounting Policies

#### Principles of Consolidation

These consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles (“GAAP”). The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. All intercompany accounts and transactions have been eliminated in consolidation. We are not the primary beneficiary of, nor do we have a controlling financial interest in, any variable interest entity. Accordingly, we have not consolidated any variable interest entity.

#### Interim Unaudited Consolidated Financial Information

The accompanying unaudited consolidated financial statements and footnotes have been prepared in accordance with GAAP as contained in the Financial Accounting Standards Board (“FASB”) Accounting Standards Codification (the “Codification” or “ASC”) for interim financial information, and with Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, the interim financial information includes all adjustments of a normal recurring nature necessary for a fair presentation of the results of operations, financial position, changes in stockholders’ equity and cash flows. The results of operations for the three- and nine-month periods ended September 30, 2017 are not necessarily indicative of the results for the full year or for any other future period. These unaudited consolidated financial statements should be read in conjunction with the audited financial statements and related footnotes for the year ended December 31, 2016 included in the Company’s Annual Report on Form 10-K filed with the United States Securities and Exchange Commission on February 24, 2017.

#### Use of Estimates

The preparation of financial statements in conformity with GAAP requires the Company to make estimates and assumptions that affect the reported amounts in the consolidated financial statements and accompanying notes. Such estimates include revenue recognition and the customer relationship period, allowances for doubtful accounts and returns, valuations of deferred income taxes, long-lived assets, warrants, capitalizable software development costs and the related amortization, stock-based compensation, the determination of the useful lives of assets, and the impairment assessment of acquired intangibles and goodwill. Determination of these transactions and account balances are based on the Company’s estimates and judgments. These estimates are based on the Company’s knowledge of current events and actions it may undertake in the future as well as on various other assumptions that it believes to be reasonable.

Actual results could differ materially from these estimates.

#### Revenue and Deferred Revenue

The Company derives the majority of its revenue from software services fees, which consist primarily of monthly subscription fees paid by customers for access to and usage of the Company's cloud-based benefits software solutions for a specified contract term. The Company also derives revenue from professional services which primarily include fees related to the integration of customers' systems with the Company's platform, which typically includes discovery, configuration, deployment, testing, and training.

The Company recognizes revenue when there is persuasive evidence of an arrangement, the service has been provided, the fees to be paid by the customer are fixed and determinable and collectability is reasonably assured. The Company considers delivery of its cloud-based software services has commenced once access to a configured and live instance to its platform has been granted to the customer.

The Company's arrangements generally contain multiple elements comprised of software services and professional services. The Company evaluates each element in an arrangement to determine whether it represents a separate unit of accounting. An element constitutes a separate unit of accounting when the delivered item has standalone value and delivery of the undelivered element is probable and within the Company's control.

When multiple deliverables included in an arrangement are separable into different units of accounting, the arrangement consideration is allocated to the identified units of accounting based on their relative selling price. Multiple deliverable arrangements accounting guidance provides a hierarchy to use when determining the relative selling price for each unit of accounting. Vendor-specific objective evidence (“VSOE”) of selling price, based on the price at which the item is regularly sold by the vendor on a standalone basis, should be used if it exists. If VSOE of selling price is not available, third-party evidence (“TPE”) of selling price is used to establish the selling price if it exists. VSOE and TPE do not currently exist for any of the Company’s deliverables. Accordingly, for arrangements with multiple deliverables that can be separated into different units of accounting, the arrangement consideration is allocated to the separate units of accounting based on the Company’s best estimate of selling price. The amount of arrangement consideration allocated is limited by contingent revenues, if any.

The Company has established standalone value for Benefitfocus Marketplace implementation services in the Employer segment. Accordingly, revenues related to implementation services for the Benefitfocus Marketplace solution in the Employer segment are recognized separately from the revenues earned from the Employer software subscription services. Revenues related to such implementation services are recognized at the time that the professional services have been completed. Certain of the Company’s other professional services, including implementation services related to the Carrier segment, are not sold separately from the software services and there is no alternative use for them. As such, the Company has determined that those professional services do not have standalone value. Accordingly, software services and professional services are combined and recognized as a single unit of accounting. The Company generally recognizes software services fees monthly based on the number of employees covered by the relevant benefits plans at contracted rates for a specified period of time, once the criteria for revenue recognition described above have been satisfied. The Company recognizes revenue on Benefitfocus Marketplace implementation services in the Employer segment that have standalone value at the time the services have been completed and the related software services have commenced. The Company defers recognition of revenue for fees from professional services that do not have standalone value and begins recognizing such revenue once the services are delivered and the related software services have commenced, ratably over the longer of the contract term or the estimated expected life of the customer relationship. Costs incurred by the Company in connection with providing such professional services are charged to expense as incurred and are included in “Cost of revenue.”

#### Concentrations of Credit Risk

The Company’s financial instruments that are exposed to concentrations of credit risk consist primarily of cash equivalents, marketable securities and accounts receivable. All of the Company’s cash and cash equivalents are held at financial institutions that management believes to be of high credit quality. The bank deposits of the Company might, at times, exceed federally insured limits and are generally uninsured and uncollateralized. The Company has not experienced any losses on cash and cash equivalents to date.

To manage credit risk related to marketable securities, the Company invests in various types of highly rated corporate bonds, commercial paper, and various U.S. government backed securities with maturities of less than two years. The weighted average maturity of the portfolio of investments must not exceed nine months, per the Company’s investment policy.

To manage accounts receivable risk, the Company evaluates the creditworthiness of its customers and maintains an allowance for doubtful accounts. Accounts receivable are unsecured and derived from revenue earned from customers located in the United States. Mercer LLC (“Mercer”) was a related party until August 24, 2017, when its beneficial ownership of the Company’s common stock went below 10%. Mercer represented approximately 14% of the total accounts receivable at December 31, 2016. Revenue from Mercer was approximately 10% of the total revenue in each of the three-month periods ended September 30, 2017 and 2016, and 11% in each of the nine-month periods ended September 30, 2017 and 2016. Accounts receivable from Mercer approximated 12% of the total accounts receivable at September 30, 2017. For more information regarding Mercer revenue, please see Note 11. Accounts receivable from one other customer approximated 13% of the total accounts receivable at December 31, 2016.

Accounts Receivable and Allowance for Doubtful Accounts and Returns

Accounts receivable are stated at realizable value, net of allowances for doubtful accounts and returns. The Company utilizes the allowance method to provide for doubtful accounts based on management's evaluation of the collectability of amounts due, and other relevant factors. Bad debt expense is recorded in general and administrative expense on the consolidated statements of operations and comprehensive loss. The Company's estimate is based on historical collection experience and a review of the current status of accounts receivable. Historically, actual write-offs for uncollectible accounts have not significantly differed from the Company's estimates. The Company removes recorded receivables and the associated allowances when they are deemed permanently uncollectible. However, if bad debts are higher than expected, future write-offs will be greater than the Company's estimates. The allowance for doubtful accounts was \$751 and \$691 as of September 30, 2017 and December 31, 2016, respectively.

The allowances for returns are accounted for as reductions of revenue and are estimated based on the Company's periodic assessment of historical experience and trends. The Company considers factors such as the time lag since the initiation of revenue recognition, historical reasons for adjustments, new customer volume, complexity of billing arrangements, timing of software availability, and past due customer billings. The allowance for returns was \$2,575 and \$3,904 as of September 30, 2017 and December 31, 2016, respectively.

#### Capitalized Software Development Costs

The Company capitalizes certain costs related to its software developed or obtained for internal use. Costs related to preliminary project activities and post-implementation activities are expensed as incurred. Internal and external costs incurred during the application development stage, including upgrades and enhancements representing modifications that will result in significant additional functionality, are capitalized. Software maintenance and training costs are expensed as incurred. Capitalized costs are recorded as part of property and equipment and are amortized on a straight-line basis to cost of revenue over the software's estimated useful life, which is three years. The Company evaluates these assets for impairment whenever events or changes in circumstances occur that could impact the recoverability of these assets.

In the three months ended September 30, 2017 and 2016, the Company capitalized software development costs of \$1,050 and \$1,129, respectively, and amortized capitalized software development costs of \$783 and \$762, respectively. In the nine months ended September 30, 2017 and 2016, the Company capitalized software development costs of \$3,379 and \$4,114, respectively, and amortized capitalized software development costs of \$2,408 and \$2,081, respectively. The net book value of capitalized software development costs was \$7,406 and \$6,435 at September 30, 2017 and December 31, 2016, respectively.

#### Comprehensive Loss

The Company's net loss equals comprehensive loss for all periods presented.

#### Recently Adopted Accounting Standards

The Company adopted the guidance in Accounting Standards Update ("ASU") 2016-09, "Compensation - Stock Compensation (Topic 718) - Improvements to Employee Share-Based Payment Accounting," on January 1, 2017. Under this ASU, entities are permitted to make an accounting policy election to either estimate forfeitures on share-based payment awards, as previously required, or to recognize forfeitures as they occur. The Company has elected to recognize forfeitures as they occur and the impact of that change in accounting policy has been recorded as a \$391 cumulative effect adjustment to its accumulated deficit as of January 1, 2017. Additionally, ASU 2016-09 requires that all income tax effects related to settlements of share-based payment awards be reported in earnings as an increase or decrease to income tax expense (benefit), net. Previously, income tax benefits at settlement of an award were reported as an increase (or decrease) to additional paid-in capital to the extent that those benefits were greater than (or less than) the income tax benefits reported in earnings during the award's vesting period. The requirement to report those income tax effects in earnings has been applied on a prospective basis to settlements occurring on or after January 1, 2017 and the impact of applying that guidance was not material to the unaudited consolidated financial statements for the three and nine months ended September 30, 2017. ASU 2016-09 also requires that all income tax-related cash flows resulting from share-based payments be reported as operating activities in the statement of cash flows. Previously, income tax benefits at settlement of an award were reported as a reduction to operating cash flows and an increase to financing cash flows to the extent that those benefits exceeded the income tax benefits reported in earnings during the award's vesting period. The Company has elected to apply that change in cash flow classification on a prospective basis. However, there is no impact to the statement of cash flows for the three and nine months ended September 30, 2017 as the Company did not have any cash flows related to excess tax benefits during that time. The remaining provisions of ASU 2016-09 did not have a material impact on the accompanying consolidated financial statements.

Accounting Standards Not Yet Adopted

In May 2017, the FASB issued ASU No. 2017-09, “Compensation—Stock Compensation (Topic 718): Scope of Modification Accounting.” The purpose of this ASU is to reduce both the diversity in practice and the cost and complexity when applying Topic 718 to a change to the terms and conditions of share-based payment awards. This guidance will be effective for the Company beginning January 1, 2018. Early adoption is permitted. The amendments in this ASU should be applied prospectively to an award modified on or after the adoption date. The Company is currently evaluating the impact of this updated standard on its consolidated financial statements.

In June 2016, the FASB issued ASU No. 2016-13, “Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments.” The purpose of this ASU is to require a financial asset measured at amortized cost basis to be presented at the net amount expected to be collected. Credit losses relating to available-for-sale debt securities should be recorded through an allowance for credit losses. This ASU is effective



for interim and annual reporting periods starting January 1, 2020. The Company is currently evaluating the impact of this guidance on its consolidated financial statements.

In February 2016, the FASB issued ASU No. 2016-02, "Leases (Topic 842)." The amendments in this update require lessees, among other things, to recognize lease assets and lease liabilities on the balance sheet for those leases classified as operating leases under previous authoritative guidance. This update also introduces new disclosure requirements for leasing arrangements. ASU 2016-02 will be effective for the Company beginning January 1, 2019. Early adoption is permitted. The Company is currently evaluating the impact of this update on its consolidated financial statements.

In May 2014, the FASB issued ASU No. 2014-09, "Revenue from Contracts with Customers (Topic 606)," which amends the revenue recognition requirements in the FASB Accounting Standards Codification. Under the new standard, revenue is recognized when a customer obtains control of promised goods or services and is recognized in an amount that reflects the consideration that the entity expects to receive in exchange for those goods and services. In addition, the standard requires disclosure of the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. The FASB has recently issued several amendments to the standard, including clarification on accounting for licenses of intellectual property and identifying performance obligations.

The standard permits two methods of adoption: retrospectively to each prior reporting period presented (full retrospective), or retrospectively with the cumulative effect of initially applying this statement recognized at the date of initial application (modified retrospective transition method). The new standard will be effective for the Company beginning January 1, 2018, with an option to early adopt. The Company plans to adopt the standard on the effective date, but has not made a determination on the adoption method.

The Company is currently assessing the impact of the new standard on its accounting policies, processes, and controls, including system requirements, and has assigned internal resources and engaged third party service providers to assist in its assessment. Based on the Company's current assessment, areas it believes might be affected by the Company's adoption of the revenue recognition standard are related to the period of recognition of deferred revenue, particularly in the Carrier segment, the estimation of variable consideration, the accounting for contract modifications, and the allocation of the transaction price to the Company's multiple performance obligations. In addition, the Company expects an impact from the adoption of the new standard related to the Company's costs to fulfill certain contracts as well as its costs to obtain contracts with customers, which are both currently expensed as incurred. The Company also is assessing the impact of this standard on the recognition of brokerage service commission revenue, the disclosure changes in its consolidated financial statements, and the transition approach that will be applied. The Company cannot reasonably estimate quantitative information related to the impact of the new standard on the Company's financial statements at this time, but anticipates the standard will have a material impact on its consolidated financial statements, particularly on deferred revenue.

### 3. Net Loss Per Common Share

Diluted loss per common share is the same as basic loss per common share for all periods presented because the effects of potentially dilutive items were anti-dilutive given the Company's net loss. The following common share equivalent securities have been excluded from the calculation of weighted average common shares outstanding because the effect is anti-dilutive for the periods presented:

Three Months Ended      Nine Months Ended

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Anti-Dilutive Common Share Equivalents	September 30,		September 30,	
	2017	2016	2017	2016
Restricted stock units	1,981,488	1,522,718	1,981,488	1,522,718
Stock options	281,840	1,393,358	281,840	1,393,358
Warrant to purchase common stock	-	580,813	-	580,813
Employee Stock Purchase Plan	3,566	-	3,566	-
Total anti-dilutive common share equivalents	2,266,894	3,496,889	2,266,894	3,496,889

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

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2017	2016	2017	2016
Numerator:				
Net loss	\$(6,674 )	\$(8,603 )	\$(18,868 )	\$(32,959 )
Net loss attributable to common stockholders	\$(6,674 )	\$(8,603 )	\$(18,868 )	\$(32,959 )
Denominator:				
Weighted-average common shares outstanding, basic and diluted	31,181,141	29,651,230	30,974,116	29,442,023
Net loss per common share, basic and diluted	\$(0.21 )	\$(0.29 )	\$(0.61 )	\$(1.12 )

#### 4. Fair Value Measurement

The carrying amounts of certain of the Company's financial instruments, including cash and cash equivalents, net accounts receivable, accounts payable and other accrued liabilities, and accrued compensation and benefits, approximate fair value due to their short-term nature. The carrying value of the Company's financing obligations and revolving line of credit approximates fair value, considering the borrowing rates currently available to the Company with similar terms and credit risks.

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

Level 1. Quoted prices (unadjusted) in active markets for identical assets or liabilities.

Level 2. Other inputs that are directly or indirectly observable in the marketplace.

Level 3. Unobservable inputs for which there is little or no market data, which require the Company to develop its own assumptions.

##### Assets and Liabilities Measured at Fair Value on a Recurring Basis

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

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The following tables present information about the Company's assets and liabilities that are measured at fair value on a recurring basis using the above categories, as of the periods presented.

Description	September 30, 2017			
	Level 1		Level 2	
	Level 1	2	3	Total
<b>Cash Equivalents:</b>				
Money market mutual funds (1)	\$49,219	\$ —	\$ —	\$49,219
<b>Total assets</b>	<b>\$49,219</b>	<b>\$ —</b>	<b>\$ —</b>	<b>\$49,219</b>

Description	December 31, 2016			
	Level 1		Level 2	
	Level 1	2	3	Total
<b>Cash Equivalents:</b>				
Money market mutual funds (1)	\$51,285	\$ —	\$ —	\$51,285
<b>Total assets</b>	<b>\$51,285</b>	<b>\$ —</b>	<b>\$ —</b>	<b>\$51,285</b>

(1) Money market funds are classified as cash equivalents in the Company's unaudited consolidated balance sheets. As short-term, highly liquid investments readily convertible to known amounts of cash with remaining maturities of three months or less at the time of purchase, the Company's cash equivalent money market funds have carrying values that approximate fair value.

#### 5. Marketable Securities

Marketable securities consist of corporate bonds, commercial paper, U.S. Treasury and agency bonds and are classified as held-to-maturity. Investments held in marketable securities had contractual maturities of less than one month as of December 31, 2016. As of September 30, 2017 the Company did not have any marketable securities. The following presents information about the Company's marketable securities as of:

	December 31, 2016
Aggregate cost basis and net carrying amount	\$ 2,007
Gross unrealized holding gains	-
Gross unrealized holding losses	-
Aggregate fair value determined by Level 2 inputs	\$ 2,007

No investments were in an unrealized loss position as of December 31, 2016.

#### 6. Revolving Line of Credit

As of September 30, 2017 and December 31, 2016, the amount outstanding under the Company's revolving line of credit was \$60,246 and \$40,246, respectively. As of September 30, 2017, the additional amount available to borrow, adjusted by the borrowing base limit, was \$7,505 and the interest rate was 5.25%.

In January 2017, the Company repaid \$20,000 of the amount outstanding under its line of credit. In March 2017, the Company borrowed \$28,000 under its line of credit for general operating purposes. In the three months ended June 30, 2017, the Company repaid \$21,000 of the amount outstanding under its line of credit. In June 2017, the Company borrowed \$25,000 for general operating purposes. In July 2017, the Company repaid \$20,000 of the amount outstanding under its line of credit. In September 2017, the Company borrowed \$28,000 for general operating purposes.

## 7. Stock-based Compensation

### Restricted Stock Units

During the nine months ended September 30, 2017, the Company granted 607,652 restricted stock units to employees and officers with an aggregate grant date fair value of \$18,147. These restricted stock units vest in equal annual installments generally over the 4 years from the grant date. The Company amortizes the grant date fair value of the stock subject to the restricted stock units on a straight-line basis over the period of vesting.

The table below sets forth information regarding performance restricted stock units granted by the Company to employees and officers during the nine months ended September 30, 2017.

## Performance Restricted Stock Units

Grant Date	Vesting Term	Vesting Range	Quantity Granted	Aggregate Grant Date Fair Value	Aggregate Grant Date Fair Value at Target
3/31/2017	1 Year	0-100	% 28,594	\$ 799	\$ 799
3/31/2017	4 Years	0-100	94,121	2,631	1,754
4/1/2017	1 Year	0-100	42,715	1,166	1,166
4/1/2017	4 Years	0-100	187,354	5,115	3,410
4/1/2017	2 Years	0-100	69,424	1,895	948
8/1/2017	4 Years	50-100	21,740	766	383
8/14/2017	1 Year	50-100	1,513	44	44
8/14/2017	4 Years	33.3-100	3,783	109	73
Total			449,244	\$ 12,525	\$ 8,577

Vesting of the performance restricted stock units is contingent upon meeting various specific annual financial and/or sales growth targets for 2017 and satisfying the respective service requirement. The actual number of shares issued upon vesting of performance restricted stock units could range from 0% to 100% of the number granted, as presented in the table. If the targets and service requirements are met, vesting occurs in equal annual installments over the various vesting terms as presented in the table. Certain awards were granted in lieu of a portion of the target cash bonus that would otherwise be payable under the Company's Management Incentive Bonus Program for the calendar year ended 2017.

## 8. Stockholders' Deficit

## Common Stock

The holders of common stock are entitled to one vote for each share. The voting, dividend and liquidation rights of the holders of common stock are subject to and qualified by the rights, powers and preferences of the holders of preferred stock.

At the 2017 annual meeting of stockholders of the Company, stockholders approved the Benefitfocus, Inc. Amended and Restated 2012 Stock Plan (the "Plan"), which increases the total number of shares of common stock reserved for issuance under the Plan by 2,700,000 shares to 9,244,525 shares and includes other administrative changes.

On August 24, 2017, warrants to purchase 580,813 shares of common stock expired unexercised.

At September 30, 2017, the Company had reserved a total of 5,083,224 of its authorized 50,000,000 shares of common stock for future issuance as follows:

Outstanding stock options	281,840
Restricted stock units	1,981,488
Available for future issuance under stock award plans	2,681,631
Available for future issuance under ESPP	138,265
Total common shares reserved for future issuance	5,083,224

## 9. Income Taxes

The Company's effective federal tax rate for the three and nine months ended September 30, 2017 was less than one percent, primarily as a result of estimated tax losses for the fiscal year to date offset by the increase in the valuation allowance in the net operating loss carryforwards. Current tax expense relates to estimated state income taxes.

## 10. Segments and Geographic Information

Operating segments are defined as components of an enterprise for which discrete financial information is available that is evaluated regularly by the chief operating decision maker ("CODM") for purposes of allocating resources and evaluating financial performance. The Company's CODM, the Chief Executive Officer, reviews financial information presented on a consolidated basis, accompanied by information about operating segments, for purposes of allocating resources and evaluating financial performance.

The Company's reportable segments are based on the type of customer. The Company determined its operating segments to be: Employer, which derives substantially all of its revenue from customers that use the

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Company's services for the provision of benefits to their employees, and administrators acting on behalf of employers; and Carrier, which derives substantially all of its revenue from insurance companies that provide coverage at their own risk.

Segments are evaluated based on gross profit. The Company does not allocate interest income, interest expense or income tax expense by segment. Accordingly, the Company does not report such information. Additionally, Employer and Carrier segments share the majority of the Company's assets. Therefore, no segment asset information is reported.

	Three Months Ended		Nine Months Ended	
			September 30,	
	September 30, 2017	September 30, 2016	September 30, 2017	September 30, 2016
Revenue from external customers by segment:				
Employer	\$40,149	\$35,371	\$119,626	\$103,825
Carrier	22,304	22,651	70,346	66,863
Total net revenue from external customers	\$62,453	\$58,022	\$189,972	\$170,688
Depreciation and amortization by segment:				
Employer	\$2,522	\$2,071	\$7,531	\$5,838
Carrier	1,381	1,238	4,317	3,781
Total depreciation and amortization	\$3,903	\$3,309	\$11,848	\$9,619
Gross profit by segment:				
Employer	\$16,603	\$13,881	\$49,876	\$41,432
Carrier	15,383	15,029	49,200	41,097
Total gross profit	\$31,986	\$28,910	\$99,076	\$82,529

## 11. Related Parties

### Related Party Leasing Arrangements

The Company leases its office space at its Charleston, South Carolina headquarters campus under the terms of three non-cancellable leases from entities with which two of the Company's directors, significant stockholders, and executives are affiliated. The Company's headquarters building lease and an additional building lease are accounted for as build-to-suit leases and recorded as financing obligations in the Consolidated Balance Sheets. The remaining lease, also for office space, is accounted for as a capital lease. The three lease agreements have 15-year terms ending on December 31, 2031, with Company options to renew for five additional years. The arrangements provide for 3.0% fixed annual rent increases. Payments under these agreements were \$2,374 and \$2,430 for the three months ended September 30, 2017 and 2016, respectively, and \$7,938 and \$8,096 for the nine months ended September 30, 2017 and 2016, respectively. Other amounts due to the related parties were \$679 and \$854 as of September 30, 2017 and December 31, 2016, respectively, and were recorded in "Accrued expenses."

### Other Related Party Expenses

The Company utilizes the services of three companies that are owned and controlled by a Company director, significant stockholder, and executive. The companies provide construction project management services and private air transportation. There were no expenses related to these companies for the three months ended September 30, 2017. Expenses related to these companies were \$13 for the three months ended September 30, 2016, and \$19 and \$50 for the nine months ended September 30, 2017 and 2016, respectively. There were no amounts due to these



companies as of September 30, 2017 or December 31, 2016.

#### Related Party Revenues

Mercer became a related party when the Company sold it over 10% beneficial ownership of the Company's outstanding common stock in February 2015. On August 24, 2017, Mercer's warrant to purchase common stock of the Company expired unexercised resulting in Mercer's beneficial ownership of the Company falling below 10%. Accordingly, as of that date, the Company no longer considers Mercer a related party. As of September 30, 2017, Mercer beneficially owned 9.0% of the Company's outstanding common stock. For the periods July 1, 2017 to August 24, 2017 and January 1, 2017 to August 24, 2017, revenue from Mercer was \$4,069 and \$18,638, respectively. For the three and nine months ended September 30, 2016, revenue from Mercer was \$5,960 and \$18,218, respectively, and was reflected in "Revenues," within the accompanying statements of operations and comprehensive loss. The amount due from Mercer was \$4,626 as of December 31, 2016. The amount of deferred revenue associated with Mercer was \$7,683 as of December 31, 2016 and was reflected in the balances of deferred revenue in the consolidated balance sheets.

### Related Party Revolving Line of Credit

In conjunction with an amendment to the Company's revolving line of credit agreement in October 2016, Goldman Sachs Lending Partners, LLC was added to the lending syndicate. Goldman Sachs Lending Partners, LLC is an affiliate of The Goldman Sachs Group, Inc., as are the Goldman Sachs funds that owned approximately 20.0% of the Company's outstanding common stock as of September 30, 2017. Goldman Sachs Lending Partners, LLC committed \$10,000 to the revolving commitment and therefore loans the Company approximately 10.5% of all amounts borrowed under the credit facility. Accordingly, amounts due to Goldman Sachs Lending Partners, LLC was approximately \$6,326 of the \$60,246 outstanding under the revolving line of credit as of September 30, 2017 and \$4,226 of the \$40,246 outstanding under the revolving line of credit as of December 31, 2016.

## 12. Subsequent Events

### Restricted Stock Units

On October 1, 2017, the Company granted 29,458 restricted stock units with an aggregate grant date fair value of \$994. The restricted stock units generally vest in equal annual installments of over 4 years from the grant date.

### Common Stock

During October 2017, employees exercised stock options and restricted stock units vested resulting in the issuance of 72,147 shares.

### Revolving Line of Credit

In October 2017, the Company repaid \$28,000 under its revolving line of credit.

SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

This Quarterly Report on Form 10-Q contains “forward-looking statements” that involve risks and uncertainties, as well as assumptions that, if they never materialize or prove incorrect, could cause our results to differ materially from those expressed or implied by such forward-looking statements. The statements contained in this Quarterly Report on Form 10-Q that are not purely historical are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, or Securities Act, and Section 21E of the Securities Exchange Act of 1934, as amended, or Exchange Act. Such forward-looking statements include any expectation of earnings, revenue or other financial items; any statements of the plans, strategies and objectives of management for future operations; factors that may affect our operating results; statements about our ability to retain and hire necessary associates and appropriately staff our operations; statements about our ability to establish and maintain intellectual property rights; statements related to future capital expenditures; statements related to future economic conditions or performance; statements as to industry trends; and other matters that do not relate strictly to historical facts or statements of assumptions underlying any of the foregoing. Forward-looking statements are often identified by the use of words such as, but not limited to, “anticipate,” “believe,” “can,” “continue,” “could,” “estimate,” “expect,” “intend,” “may,” “might,” “will,” “plan,” “project,” “would,” and similar expressions or variations intended to identify forward-looking statements. These statements are based on the beliefs and assumptions of our management based on information currently available to management. Such forward-looking statements are subject to risks, uncertainties and other important factors that could cause actual results and the timing of certain events to differ materially from future results expressed or implied by such forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those discussed in the section titled “Risk Factors” included in Item 1A of Part II of this Quarterly Report on Form 10-Q, and the risks discussed in our other SEC filings. Furthermore, such forward-looking statements speak only as of the date of this report. Except as required by law, we undertake no obligation to update any forward-looking statements to reflect events or circumstances after the date of such statements.

As used in this report, the terms “Benefitfocus, Inc.,” “Benefitfocus,” “Company,” “company,” “we,” “us,” and “our” mean Benefitfocus, Inc. and its subsidiaries unless the context indicates otherwise.

## ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our consolidated financial statements and related notes appearing elsewhere in this Quarterly Report on Form 10-Q and with the financial statements, related notes and Management's Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K for the fiscal year ended December 31, 2016. The following discussion contains forward-looking statements that reflect our plans, estimates and beliefs. Our actual results could differ materially from those discussed in the forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those discussed in the section titled "Risk Factors" included in Item 1A of Part II of this Quarterly Report on Form 10-Q, and the risks discussed in our other SEC filings.

### Overview

Benefitfocus provides a leading cloud-based benefits management platform for consumers, employers, insurance carriers, and brokers. The Benefitfocus Platform simplifies how organizations and individuals shop for, enroll in, manage, and exchange benefits. Our employer and insurance carrier customers rely on our platform to manage, scale and exchange data. Our web-based platform has a user-friendly interface designed to enable the insured consumers to access all of their benefits in one place. Our comprehensive solutions support core benefits plans, including healthcare, dental, life, and disability insurance, and voluntary benefits offerings such as income protection, digital health and financial wellness. As the number of employer benefits plans has increased, with each plan subject to many different business rules and requirements, demand for the Benefitfocus Platform has grown.

We serve two separate but related market segments. Our fastest growing market segment, the employer market, consists of employers offering benefits to their employees. Within this segment, we mainly target large employers with more than 1,000 employees, of which we believe there are over 18,000 in the United States. In our other market segment, we sell our solutions to insurance carriers, enabling us to expand our overall footprint in the benefits marketplace by aggregating many key constituents, including consumers, employers, and brokers. Our business model capitalizes on the close relationship between carriers and their members, and the carriers' ability to serve as lead generators for potential employer customers. Carriers pay for services at a rate reflective of the aggregated nature of their customer base on a per application basis. Carriers can then deploy their applications to employer groups and members. As employers become direct customers through our employer segment, we provide them our platform offering that bundles many software applications into a comprehensive benefits solution through Benefitfocus Marketplace. We believe our presence in both the employer and insurance carrier markets gives us a strong position at the center of the benefits ecosystem.

We sell the Benefitfocus Platform on a subscription basis, typically through annual contracts with employer customers and multi-year contracts with our insurance carrier customers, with subscription fees paid monthly, quarterly and annually. The multi-year contracts with our carrier customers are generally only cancellable by the carrier in an instance of our uncured breach, although some of our carrier customers are able to terminate their respective contracts without cause or for convenience. Software services revenue accounted for approximately 85% of our total revenue during each of the three-month periods ended September 30, 2017 and 2016, and 86% and 88% of our total revenue during the nine months ended September 30, 2017 and 2016, respectively.

Another component of our revenue is professional services. We derive the majority of our professional services revenue from the implementation of our customers onto our platform, which typically includes discovery, configuration and deployment, integration, testing, and training. In general, it takes from four to five months to implement a new employer customer's benefits systems and eight to 10 months to implement a new carrier customer's benefits systems. We also provide customer support services and customized media content that supports our customers' effort to educate and communicate with consumers. Professional services revenue accounted for approximately 15% of our total revenue during each of the three-month periods ended September 30, 2017 and 2016,

and 14% and 13% of our total revenue during the nine months ended September 30, 2017 and 2016, respectively.

Increasing our base of large employer customers is an important source of revenue growth for us. We actively pursue new employer customers in the U.S. market, and we have increased the number of large employer customers utilizing our solutions from 141 as of December 31, 2010 to 903 as of September 30, 2017. We believe that our continued innovation and new solutions, such as online benefits marketplaces, also known as private exchanges, enhanced mobile offerings, and more robust data analytics capabilities will help us attract additional large employer customers and increase our revenue from existing customers.

We believe that there is a substantial market for our services, and we have been investing in growth over the past five years. In particular, we have continued to invest in technology and services to better serve our larger employer customers, which we believe are an important source of growth for our business. We have also substantially increased our marketing and sales efforts and expect those increased efforts to continue. As we have invested in growth, we have had operating losses in each of the last six years, and expect our operating losses to

continue for at least the next year. Due to the nature of our customer relationships, which have been stable in spite of some customer losses over the past years, and the subscription nature of our financial model, we believe that our current investment in growth should lead to substantially increased revenue, which will allow us to achieve profitability in the relatively near future. Of course, our ability to achieve profitability will continue to be subject to many factors beyond our control.

#### Key Financial and Operating Performance Metrics

We regularly monitor a number of financial and operating metrics in order to measure our current performance and project our future performance. These metrics help us develop and refine our growth strategies and make strategic decisions. We discuss revenue, gross margin, and the components of operating loss, as well as segment revenue and segment gross profit, in “Management’s Discussion and Analysis of Financial Condition and Results of Operations—Components of Operating Results”. In addition, we utilize other key metrics as described below.

#### Number of Large Employer and Carrier Customers

We believe the number of large employer and carrier customers is a key indicator of our market penetration, growth, and future revenue. We intend to continue to invest in our sales force to grow our customer base. We generally define a customer as an entity with an active software services contract as of the measurement date. The following table sets forth the number of large employer and carrier customers for the periods indicated:

	As of September 30,	
	2017	2016
Number of customers:		
Large employer	903	827
Carrier	54	53

#### Software Services Revenue Retention Rate

We believe that our ability to retain our customers and expand the revenue they generate for us over time is an important component of our growth strategy and reflects the long-term value of our customer relationships. We measure our performance on this basis using a metric we refer to as our software services revenue retention rate. We calculate this metric for a particular period by establishing the group of our customers that had active contracts for a given period. We then calculate our software services revenue retention rate by taking the amount of software services revenue we recognized for this group in the subsequent comparable period (for which we are reporting the rate) and dividing it by the software services revenue we recognized for the group in the prior period.

For the three- and nine-month periods ended September 30, 2017 and 2016, our software services revenue retention rate exceeded 95%.

#### Adjusted EBITDA

Adjusted EBITDA represents our earnings before net interest, taxes, and depreciation and amortization expense, adjusted to eliminate stock-based compensation, impairment of goodwill and intangible assets, and costs not core to our business. We believe that the exclusion of the expenses eliminated 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. However, adjusted EBITDA is not a measure calculated in accordance with United States generally accepted accounting principles, or GAAP, and should not be considered as an alternative to any measure of financial performance calculated and presented in accordance with GAAP.

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

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

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

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

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Adjusted EBITDA does not reflect interest or tax payments that would reduce the cash available to us; and other companies, including companies in our industry, might calculate adjusted EBITDA or a similarly titled measure differently, which reduces their usefulness as comparative measures.

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

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2017	2016	2017	2016
<b>Reconciliation from Net Loss to Adjusted EBITDA:</b>				
Net loss	\$(6,674 )	\$(8,603 )	\$(18,868 )	\$(32,959 )
Depreciation	3,053	2,482	9,245	7,344
Amortization of software development costs	785	762	2,409	2,081
Amortization of acquired intangible assets	65	65	194	194
Interest income	(55 )	(25 )	(129 )	(117 )
Interest expense on building lease financing obligations	1,864	1,704	5,585	5,130
Interest expense on other borrowings	1,254	262	3,526	691
Income tax expense	5	5	10	15
Stock-based compensation expense	4,396	4,427	11,646	13,610
Costs not core to our business	359	-	480	-
Total net adjustments	11,726	9,682	32,966	28,948
Adjusted EBITDA	\$5,052	\$1,079	\$14,098	\$(4,011 )

Components of Operating Results

Revenue

We derive the majority of our revenue from software services fees, which consist primarily of monthly subscription fees paid to us by our employer and carrier customers for access to, and usage of, our cloud-based benefits software solutions for a specified contract term. We also derive revenue from professional services fees, which primarily include fees related to the implementation of our customers onto our platform. Our professional services typically include discovery, configuration and deployment, integration, testing, and training.

The following table sets forth a breakdown of our revenue between software services and professional services for the periods indicated (in thousands):

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2017	2016	2017	2016
Software services	\$53,125	\$49,296	\$163,399	\$149,309
Professional services	9,328	8,726	26,573	21,379
Total revenue	\$62,453	\$58,022	\$189,972	\$170,688



We generally recognize software services fees monthly based on the number of employees covered by the relevant benefits plans at contracted rates for a specified period of time, provided that an enforceable contract has been signed by both parties, access to our software has been granted to the customer and it is available for their use, the fee for the software services is fixed or determinable, and collection is reasonably assured.

We recognize revenue from professional services with standalone value, for example implementation services for the Benefitfocus Marketplace solution in the Employer segment, at the time that the professional services have been completed. We defer recognition of our professional services fees paid by customers related to implementation services that are determined to not have stand-alone value and are sold with our software services, and recognize them, beginning once the software services have commenced, ratably over the longer of the contract term or the estimated expected life of the customer relationship, which was 7 years. We periodically evaluate the term over which revenue is recognized for professional services as we gain more experience with customer contract renewals.

We generally invoice our employer and carrier customers for software services in advance, in monthly, quarterly or annual installments. We invoice our employer customers for implementation fees at the inception of the arrangement. We generally invoice our carrier customers for implementation fees at various contractually defined times throughout the implementation process. Implementation fees that have been invoiced are initially recorded as deferred revenue until recognized to revenue as described above.

We earn commissions from brokerage services from our voluntary benefit insurance offerings. We recognize revenue when these commissions are earned.

#### Overhead Allocation

Expenses associated with our facilities, security, information technology, and depreciation and amortization, are allocated between cost of revenue and operating expenses based on employee headcount determined by the nature of work performed.

#### Cost of Revenue

Cost of revenue primarily consists of salaries and other personnel-related costs, including benefits, bonuses, and stock-based compensation, for employees, whom we refer to as associates, providing services to our customers and supporting our SaaS platform infrastructure. Additional expenses in cost of revenue include co-location facility costs for our data centers, depreciation expense for computer equipment directly associated with generating revenue, infrastructure maintenance costs, professional fees, amortization expenses associated with capitalized software development costs, allocated overhead, and other direct costs.

We expense our cost of revenue as we incur the costs. However, the related revenue from fees we receive for our implementation services, performed before a customer is operating on our platform, that is determined to not have stand-alone value is deferred until the commencement of the monthly subscription and recognized as revenue ratably over the longer of the related contract term or the estimated expected life of the customer relationship. For those implementation services that have standalone value, the related revenue is recognized as revenue upon completion of service. Therefore, the cost incurred in providing these services is expensed in periods prior to the recognition of the corresponding revenue. Our cost associated with providing implementation services has been significantly higher as a percentage of revenue than our cost associated with providing our monthly subscription services due to the labor associated with implementation.

We plan to continue to expand our capacity to support our growth, which will result in higher cost of revenue in absolute dollars. However, we expect cost of revenue as a percentage of revenue to decline and gross margins to increase primarily from the growth of the percentage of our revenue from large employers and the realization of economies of scale driven by retention of our customer base.

#### Operating Expenses

Operating expenses consist of sales and marketing, research and development, and general and administrative expenses. Salaries and personnel-related costs are the most significant component of each of these expense categories. We expect to continue to hire new associates in these areas in order to support our anticipated revenue growth; however, we expect to decrease our operating expenses, as a percentage of revenue, as we achieve economies of scale.

**Sales and marketing expense.** Sales and marketing expense consists primarily of salaries and other personnel-related costs, including benefits, bonuses, stock-based compensation, and commissions for our sales and marketing associates. We record expense for commissions at the time of contract signing. Additional expenses include advertising, lead generation, promotional event programs, corporate communications, travel, and allocated overhead. For instance, our most significant promotional event is One Place, which we have held annually. We expect our sales

and marketing expense to increase, in absolute dollars, in the foreseeable future as we further increase the number of our sales and marketing professionals and expand our marketing activities in order to continue to grow our business.

Research and development expense. Research and development expense consists primarily of salaries and other personnel-related costs, including benefits, bonuses, and stock-based compensation for our research and development associates. Additional expenses include costs related to the development, quality assurance, and testing of new technology, and enhancement of our existing platform technology, consulting, travel, and allocated overhead. We believe continuing to invest in research and development efforts is essential to maintaining our competitive position. We expect our research and development expense to decrease, as a percentage of revenue, as we achieve economies of scale.

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General and administrative expense. General and administrative expense consists primarily of salaries and other personnel-related costs, including benefits, bonuses, and stock-based compensation for administrative, finance and accounting, information systems, legal, and human resource associates. Additional expenses include consulting and professional fees, insurance and other corporate expenses, and travel. We expect our general and administrative expenses to increase in absolute terms as a result of ongoing public company costs, including those associated with compliance with the Sarbanes-Oxley Act and other regulations governing public companies, increased costs of directors' and officers' liability insurance, and increased professional services expenses, particularly associated with the new revenue recognition standard.

Other Income and Expense

Other income and expense consists primarily of interest income and expense and gain (loss) on disposal of property and equipment. Interest income represents interest received on our cash and cash equivalents and marketable securities. Interest expense consists primarily of the interest incurred on outstanding borrowings under our financing obligations, capital leases and credit facility.

Income Tax Expense

Income tax expense consists of U.S. federal and state income taxes. We incurred minimal income tax expense for the three and nine months ended September 30, 2017 and 2016.

Results of Operations

Consolidated Statements of Operations Data

The following table sets forth our consolidated statements of operations data for each of the periods indicated (in thousands).

	Three Months Ended		Nine Months Ended	
	September 30, 2017	September 30, 2016	September 30, 2017	September 30, 2016
Revenue	\$62,453	\$58,022	\$189,972	\$170,688
Cost of revenue <sup>(1)</sup>	30,467	29,112	90,896	88,159
Gross profit	31,986	28,910	99,076	82,529
Operating expenses:				
Sales and marketing <sup>(1)</sup>	16,180	13,607	51,103	41,942
Research and development <sup>(1)</sup>	12,568	14,081	37,222	43,276
General and administrative <sup>(1)</sup>	6,853	7,746	20,487	24,415
Total operating expenses	35,601	35,434	108,812	109,633
Loss from operations	(3,615 )	(6,524 )	(9,736 )	(27,104 )
Other income (expense):				
Interest income	55	25	129	117
Interest expense on building lease financing obligations	(1,864 )	(1,704 )	(5,585 )	(5,130 )
Interest expense on other borrowings	(1,254 )	(262 )	(3,526 )	(691 )
Other income (expense)	9	(133 )	(140 )	(136 )
Total other expense, net	(3,054 )	(2,074 )	(9,122 )	(5,840 )
Loss before income taxes	(6,669 )	(8,598 )	(18,858 )	(32,944 )
Income tax expense	5	5	10	15
Net loss	\$(6,674 )	\$(8,603 )	\$(18,868 )	\$(32,959 )

(1) Cost of revenue and operating expenses include stock-based compensation expense as follows (in thousands):

	Three Months Ended		Nine Months Ended	
	September 30, 2017	September 30, 2016	September 30, 2017	September 30, 2016
Cost of revenue	\$682	\$754	\$1,803	\$2,072
Sales and marketing	1,319	886	3,575	2,356
Research and development	743	1,011	2,200	3,538
General and administrative	1,652	1,776	4,068	5,644

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The following table sets forth our consolidated statements of operations data as a percentage of revenue for each of the periods indicated (as a percentage of revenue):

	Three Months Ended		Nine Months Ended	
	September 30, 2017	September 30, 2016	September 30, 2017	September 30, 2016
Revenue	100.0 %	100.0 %	100.0 %	100.0 %
Cost of revenue	48.8	50.2	47.8	51.6
Gross profit	51.2	49.8	52.2	48.4
Operating expenses:				
Sales and marketing	25.9	23.5	26.9	24.6
Research and development	20.1	24.3	19.6	25.4
General and administrative	11.0	13.4	10.8	14.3
Total operating expenses	57.0	61.1	57.3	64.2
Loss from operations	(5.8 )	(11.2 )	(5.1 )	(15.9 )
Other income (expense):				
Interest income	0.1	-	0.1	0.1
Interest expense on building lease financing obligations	(3.0 )	(2.9 )	(2.9 )	(3.0 )
Interest expense on other borrowings	(2.0 )	(0.5 )	(1.9 )	(0.4 )
Other income (expense)	-	(0.2 )	(0.1 )	(0.1 )
Total other expense, net	(4.9 )	(3.6 )	(4.8 )	(3.4 )
Loss before income taxes	(10.7 )	(14.8 )	(9.9 )	(19.3 )
Income tax expense	-	-	-	-
Net loss	(10.7 )%	(14.8 )%	(9.9 )%	(19.3 )%

Our Segments

The following table sets forth segment results for revenue and gross profit for the periods indicated (in thousands):

	Three Months Ended		Nine Months Ended	
	September 30, 2017	September 30, 2016	September 30, 2017	September 30, 2016
Revenue from external customers by segment:				
Employer	\$40,149	\$35,371	\$119,626	\$103,825
Carrier	22,304	22,651	70,346	66,863
Total net revenue from external customers	\$62,453	\$58,022	\$189,972	\$170,688
Gross profit by segment:				
Employer	\$16,603	\$13,881	\$49,876	\$41,432
Carrier	15,383	15,029	49,200	41,097
Total gross profit	\$31,986	\$28,910	\$99,076	\$82,529

## Comparison of Three Months Ended September 30, 2017 and 2016

## Revenue

	Three Months Ended September 30, 2017		2016		Period-to-Period Change			
	Amount (in thousands)	Percentage of	Amount	Percentage of	Amount	Percentage		
		Revenue		Revenue			Change	Change
Software services	\$53,125	85.1 %	\$49,296	85.0 %	\$ 3,829	7.8 %		
Professional services	9,328	14.9 %	8,726	15.0 %	602	6.9 %		
Total revenue	\$62,453	100.0 %	\$58,022	100.0 %	\$ 4,431	7.6 %		

Growth in software services revenue in absolute terms was primarily attributable to existing customers adding covered lives to our offerings, or volume increases, and purchasing additional products, as well as the net addition of new customers, as the number of large employer and carrier customers increased to 957 as of September 30, 2017 from 880 as of September 30, 2016.

The increase in professional services revenue was attributable to customer-specific consulting and enhancements partially offset by decreases in implementation revenue.

## Segment Revenue

	Three Months Ended September 30, 2017		2016		Period-to-Period Change			
	Amount (in thousands)	Percentage of	Amount	Percentage of	Amount	Percentage		
		Revenue		Revenue			Change	Change
Employer	\$40,149	64.3 %	\$35,371	61.0 %	\$ 4,778	13.5 %		
Carrier	22,304	35.7 %	22,651	39.0 %	(347 )	(1.5 )		
Total revenue	\$62,453	100.0 %	\$58,022	100.0 %	\$ 4,431	7.6 %		

Growth in our employer revenue in absolute terms was primarily attributable to a \$4.6 million increase in our employer software services revenue driven by volume increases and additional products sold to existing customers, as well as the addition of new customers.

The decrease in carrier revenue in absolute terms was primarily attributable to a decrease of \$0.8 million in software services revenue offset by a \$0.4 million increase in professional services revenue. The decrease in carrier software services revenue was primarily driven by a large carrier customer that transitioned a segment of its business from our platform to an internal solution.

## Cost of Revenue

	Three Months Ended September 30, 2017		2016		Period-to-Period Change	
	Amount	Percentage of Revenue	Amount	Percentage of Revenue	Amount	Percentage
	(in thousands)					
Cost of revenue	\$30,467	48.8	% \$29,112	50.2	% \$ 1,355	4.7 %

The increase in cost of revenue in absolute terms was attributable to an increase in salaries, personnel-related costs and professional fees to support our growing customer base and platform. Cost of revenue decreased as a percentage of revenue as we continue to achieve economies of scale.

## Gross Profit

	Three Months Ended September 30, 2017		2016		Period-to-Period Change	
	Amount	Percentage of Revenue	Amount	Percentage of Revenue	Amount	Percentage
	(in thousands)					