

Benefitfocus, Inc.
Form 10-Q
November 02, 2018

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: 001-36061

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

Edgar Filing: Benefitfocus, Inc. - Form 10-Q

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 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, 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 29, 2018, there were approximately 31,960,547 shares of the registrant's common stock outstanding.

Benefitfocus, Inc.

Form 10-Q

For the Quarterly Period Ended September 30, 2018

TABLE OF CONTENTS

PART I. FINANCIAL INFORMATION

<u>ITEM 1. FINANCIAL STATEMENTS</u>	3
<u>Unaudited Consolidated Balance Sheets as of September 30, 2018 and December 31, 2017</u>	3
<u>Unaudited Consolidated Statements of Operations and Comprehensive Loss for the Three and Nine Months Ended September 30, 2018 and 2017</u>	4
<u>Unaudited Consolidated Statement of Changes in Stockholders' Deficit for the Nine Months Ended September 30, 2018</u>	5
<u>Unaudited Consolidated Statements of Cash Flows for the Nine Months Ended September 30, 2018 and 2017</u>	6
<u>Notes to Unaudited Consolidated Financial Statements</u>	7
<u>ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS</u>	17
<u>ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK</u>	29
<u>ITEM 4. CONTROLS AND PROCEDURES</u>	30
PART II. OTHER INFORMATION	
<u>ITEM 1A. RISK FACTORS</u>	31
<u>ITEM 6. EXHIBITS</u>	48
<u>SIGNATURES</u>	49

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,
	2018	2017
Assets		
Current assets:		
Cash and cash equivalents	\$51,065	\$55,335
Accounts receivable, net	27,624	30,091
Contract, prepaid and other current assets	10,780	15,859
Total current assets	89,469	101,285
Property and equipment, net	70,208	72,681
Intangible assets, net	—	150
Goodwill	1,634	1,634
Deferred contract costs and other non-current assets	13,838	16,253
Total assets	\$175,149	\$192,003
Liabilities and stockholders' deficit		
Current liabilities:		
Accounts payable	\$6,868	\$4,260
Accrued expenses	10,582	9,110
Accrued compensation and benefits	13,182	14,250
Deferred revenue, current portion	37,711	43,804
Revolving line of credit, current portion	30,000	24,000
Financing and capital lease obligations, current portion	4,115	3,423
Total current liabilities	102,458	98,847
Deferred revenue, net of current portion	9,873	11,223
Revolving line of credit, net of current portion	39,246	32,246
Financing and capital lease obligations, net of current portion	56,664	55,597
Other non-current liabilities	2,480	2,809
Total liabilities	210,721	200,722
Commitments and contingencies		
Stockholders' deficit:		
Preferred stock, par value \$0.001, 5,000,000 shares authorized,		
no shares issued and outstanding at September 30, 2018		
and December 31, 2017	—	—
Common stock, par value \$0.001, 50,000,000 shares authorized,	32	31

Edgar Filing: Benefitfocus, Inc. - Form 10-Q

31,899,960 and 31,307,989 shares issued and outstanding		
at September 30, 2018 and December 31, 2017, respectively		
Additional paid-in capital	365,303	352,496
Accumulated deficit	(400,907)	(361,246)
Total stockholders' deficit	(35,572)	(8,719)
Total liabilities and stockholders' deficit	\$ 175,149	\$ 192,003

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,	
	2018	2017	2018	2017
Revenue	\$61,006	\$56,251	\$183,950	\$168,963
Cost of revenue	31,740	31,310	93,864	93,208
Gross profit	29,266	24,941	90,086	75,755
Operating expenses:				
Sales and marketing	17,661	16,467	55,978	52,353
Research and development	10,676	12,568	34,827	37,222
General and administrative	9,263	6,853	29,343	20,487
Total operating expenses	37,600	35,888	120,148	110,062
Loss from operations	(8,334)	(10,947)	(30,062)	(34,307)
Other expense:				
Interest income	73	55	199	129
Interest expense on building lease financing obligations	(1,868)	(1,864)	(5,601)	(5,585)
Interest expense on other borrowings	(1,458)	(1,254)	(4,190)	(3,526)
Other income (expense)	2	9	15	(140)
Total other expense, net	(3,251)	(3,054)	(9,577)	(9,122)
Loss before income taxes	(11,585)	(14,001)	(39,639)	(43,429)
Income tax expense	13	5	22	10
Net loss	\$(11,598)	\$(14,006)	\$(39,661)	\$(43,439)
Comprehensive loss	\$(11,598)	\$(14,006)	\$(39,661)	\$(43,439)
Net loss per common share:				
Basic and diluted	\$(0.36)	\$(0.45)	\$(1.25)	\$(1.40)
Weighted-average common shares outstanding:				
Basic and diluted	31,883,029	31,181,141	31,678,360	30,974,116

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, 2017 (as previously reported)	31,307,989	\$ 31	\$ 355,301	\$ (394,663)	\$ (39,331)
Adoption of revenue recognition standard	—	—	(2,805)	33,417	30,612
Balance, December 31, 2017	31,307,989	\$ 31	\$ 352,496	\$ (361,246)	\$ (8,719)
Exercise of stock options	9,250	—	42	—	42
Issuance of common stock upon vesting of restricted stock units	15,208	—	—	—	—
Issuance of common stock under Employee Stock Purchase Plan, or ESPP	7,022	—	180	—	180
Stock-based compensation expense	—	—	4,325	—	4,325
Net loss	—	—	—	(13,802)	(13,802)
Balance, March 31, 2018	31,339,469	\$ 31	\$ 357,043	\$ (375,048)	\$ (17,974)
Exercise of stock options	4,578	—	48	—	48
Issuance of common stock upon vesting of restricted stock units	481,950	1	(1)	—	—
Stock-based compensation expense	—	—	4,674	—	4,674
Net loss	—	—	—	(14,261)	(14,261)
Balance, June 30, 2018	31,825,997	\$ 32	\$ 361,764	\$ (389,309)	\$ (27,513)
Exercise of stock options	1,230	—	13	—	13
Issuance of common stock upon vesting of restricted stock units	67,142	—	—	—	—
Issuance of common stock under Employee Stock Purchase Plan, or ESPP	5,591	—	179	—	179
Stock-based compensation expense	—	—	3,347	—	3,347
Net loss	—	—	—	(11,598)	(11,598)
Balance, September 30, 2018	31,899,960	\$ 32	\$ 365,303	\$ (400,907)	\$ (35,572)

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, 2018	2017
Cash flows from operating activities		
Net loss	\$ (39,661)	\$ (43,439)
Adjustments to reconcile net loss to net cash and cash equivalents used in operating activities:		
Depreciation and amortization	11,912	11,848
Stock-based compensation expense	12,346	11,646
Interest accrual on financing obligation	5,639	5,623
Loss on disposal or impairment of property and equipment	—	157
Provision for doubtful accounts	364	142
Changes in operating assets and liabilities:		
Accounts receivable, net	2,103	(443)
Accrued interest on short-term investments	—	7
Contract, prepaid and other current assets	5,179	9,561
Deferred contract costs and other non-current assets	2,590	4,372
Accounts payable and accrued expenses	4,385	(6,560)
Accrued compensation and benefits	(1,068)	(5,422)

Edgar Filing: Benefitfocus, Inc. - Form 10-Q

Deferred revenue	(7,443)	(1,809)
Other non-current liabilities	(328)	(751)
Net cash and cash equivalents used in operating activities	(3,982)	(15,068)
Cash flows from investing activities		
Proceeds from maturity of short-term investments held to maturity	—	2,000
Purchases of property and equipment	(5,855)	(6,151)
Net cash and cash equivalents used in investing activities	(5,855)	(4,151)
Cash flows from financing activities		
Draws on revolving line of credit	97,000	81,000
Payments on revolving line of credit	(84,000)	(61,000)
Proceeds from exercises of stock options and ESPP	462	3,572
Payments on financing and capital lease obligations	(7,895)	(6,633)
Net cash and cash equivalents provided by financing activities	5,567	16,939
Net decrease in cash and cash equivalents	(4,270)	(2,280)
Cash and cash equivalents, beginning of period	55,335	56,853
Cash and cash equivalents, end of period	\$ 51,065	\$ 54,573
Supplemental disclosure of non-cash investing and financing activities		
Property and equipment purchases	\$ 83	\$ 878

in accounts payable
and accrued expenses

Property and
equipment purchased
with financing and
capital lease
obligations

\$ 3,739

\$ —

Post contract support
purchased with
financing obligations

\$ 275

\$ —

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, 2018 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, 2017 included in the Company’s Annual Report on Form 10-K, as amended.

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 allowances for doubtful accounts and returns, valuations of deferred income taxes, long-lived assets, capitalizable software development costs and the related amortization, stock-based compensation, the determination of the useful lives of assets and the impairment assessment of goodwill as well as the estimates disclosed in association with revenue recognition. Determination of these transactions and account balances are based on, among other things, 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

The Company derives its revenues primarily from fees for software services and professional services sold to employers and insurance carriers. Revenues are recognized when control of these services is transferred to customers, in an amount that reflects the consideration the Company expects to be entitled to in exchange for those services. Taxes collected from customers relating to services and remitted to governmental authorities are excluded from revenues.

The Company determines revenue recognition through the following steps:

- 1 Identification of each contract with a customer;
- 2 Identification of the performance obligations in the contract;
- 3 Determination of the transaction price;
- 4 Allocation of the transaction price to the performance obligations in the contract; and
- 5 Recognition of revenue when, or as, performance obligations are satisfied.

Software Services Revenues

Software services revenues primarily consist of monthly subscription fees paid to the Company by its employer and insurance carrier customers for access to, and usage of, cloud-based benefits software solutions for a specified contract term. Fees are generally charged based on the number of employees or subscribers with access to the solution. Software services revenue also includes insurance broker commissions from the sale of voluntary and ancillary benefits policies to employees of the Company's customers.

Software services revenues are generally recognized on a ratable basis over the contract term beginning on the date the software services are made available to the customer. The Company's software service contracts are generally three years for both

carrier and employer customers. Revenue from insurance broker commissions is recognized when the orders for the policies are received and transferred to the insurance carrier, and is reduced by estimates for risks from collectability, policy cancellation and termination.

Professional Services Revenues

Professional services revenues primarily consist of fees related to the implementation of software products purchased by customers. Professional services typically include discovery, configuration and deployment, integration, testing, and training. Fees from consulting services, support services and training are also included in professional services revenue.

Revenue from implementation services with customers in the Carrier segment are generally recognized over the contract term of the associated software services contract, including any extension periods representing a material right. The Company utilizes estimates of hours as a measure of progress to determine revenue in certain arrangements.

Revenues from implementation services with customers in the Employer segment are generally recognized as those services are performed.

Revenues from support and training fees are recognized over the service contract period.

Contracts with Multiple Performance Obligations

Certain of the Company's contracts with customers contain multiple performance obligations. For these contracts, the individual performance obligations are accounted for separately if they are distinct. The Company allocates the transaction price to the separate performance obligations based on their relative standalone selling prices. The Company determines the standalone selling prices based on its overall pricing objectives, taking into consideration market conditions and other factors, including the value of its contracts, the software services sold, customer size and complexity, and the number and types of users under the contracts.

Practical Expedients Elected

In addition to practical expedients disclosed elsewhere in the notes to unaudited consolidated financial statements, the Company has elected to use the practical expedient not to adjust the promised amount of consideration for the effects of a significant financing component for contracts in which the period between transferring a service to a customer and when the customer pays for that service is one year or less.

Contract Costs

The Company capitalizes costs to obtain contracts that are considered incremental and recoverable, such as sales commissions. Payments of sales commissions generally include multiple payments. The Company capitalizes only those payments made within an insignificant time from the contract inception, typically three months or less. Subsequent payments are expensed as incurred. The capitalized costs are amortized to sales and marketing expense over the estimated period of benefit of the asset, which is generally four to five years. The Company has elected to use the practical expedient to expense the costs to obtain a contract when the amortization period is less than one year. The balance of deferred costs related to obtaining contracts included in deferred contract costs and other non-current assets was \$7,429 and \$7,376 as of September 30, 2018 and December 31, 2017, respectively. Sales and marketing expense includes \$1,019 and \$1,089 of amortization for the three months ended September 30, 2018 and 2017, respectively, and \$3,180 and \$3,393 for the nine months ended September 30, 2018 and 2017, respectively.

The Company capitalizes contract fulfillment costs directly associated with customer contracts that are not related to satisfying performance obligations. The costs are amortized to cost of revenue expense over the estimated period of

benefit, which is generally five years. The balance of deferred fulfillment costs included in deferred contract costs and other non-current assets was \$5,746 and \$8,060 as of September 30, 2018 and December 31, 2017, respectively. Cost of revenue expense includes \$861 and \$887 of amortization for the three months ended September 30, 2018 and 2017, respectively, and \$2,640 and \$2,609 for the nine months ended September 30, 2018 and 2017, respectively.

Concentrations of Credit Risk

The Company's financial instruments that are exposed to concentrations of credit risk consist primarily of cash equivalents 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 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. No customer represented more than 10% of total accounts receivable as of September 30, 2018. Accounts receivable from one customer represented approximately 12% of the total accounts receivable as of December 31, 2017. Revenue from one customer was approximately 13% of the total revenue in each of the three-month periods ended September 30, 2018 and 2017, respectively, and 14% and 12% of the total revenue in the nine-month period ended September 30, 2018 and 2017, respectively.

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 in 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. The Company removes recorded receivables and the associated allowances when they are deemed permanently uncollectible. Historically, actual write-offs for uncollectible accounts have not significantly differed from the Company's estimates. 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 \$458 and \$654 as of September 30, 2018 and December 31, 2017, 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 historical reasons for adjustments, changes in customer volume, complexity of billing arrangements, software availability, and past due customer billings. The allowance for returns was \$2,438 and \$2,877 as of September 30, 2018 and December 31, 2017, 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, 2018 and 2017, the Company capitalized software development costs of \$1,688 and \$1,050, respectively, and amortized capitalized software development costs of \$1,045 and \$784, respectively. In the nine months ended September 30, 2018 and 2017, the Company capitalized software development costs of \$4,287 and \$3,379, respectively, and amortized capitalized software development costs of \$2,898 and \$2,408, respectively. The net book value of capitalized software development costs was \$9,050 and \$7,660 at September 30, 2018 and December 31, 2017, respectively.

Comprehensive Loss

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

Recently Adopted Accounting Standards

Cloud Computing Arrangements

In August 2018, the FASB issued Accounting Standards Update ("ASU") 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." The ASU allows companies to capitalize implementation costs incurred in a hosting arrangement that is a service contract over the term of the arrangement, including periods covered by renewal options that are reasonably certain to be exercised. The Company early adopted this standard in the quarter ended September 30, 2018. There was no impact on the Company's consolidated financial statements upon adoption.

Revenue from Contracts with Customers

On January 1, 2018, the Company adopted ASU No. 2014-09, "Revenue from Contracts with Customers (Topic 606)," applying the full retrospective transition method to all contracts that were not completed as of January 1, 2016, the initial date of application.

The adoption of Topic 606 significantly affected the accounting for revenue from certain professional services in the Carrier segment and insurance broker commission revenue included in software services revenue in the Employer segment.

Prior to the adoption of Topic 606, the Company recognized revenue from certain professional services in the Carrier segment over the customer relationship period. Under Topic 606, revenue from certain of these services are recognized over the contract term of the associated software services contract, including any extension periods representing a material right, which can be shorter than the customer relationship period. The financial statement impact of this change is a reduction to the deferred revenue balance as of the date of adoption.

Also prior to the adoption of Topic 606, the Company recognized insurance broker commission revenue over the policy period. Under Topic 606, the revenue related to broker commissions is recognized when the performance obligation has been satisfied, which is when the orders for the policies are received and transferred to the insurance carrier. As a result, software services revenue from these arrangements in the Employer segment is recognized in the aggregate and earlier under Topic 606 in comparison to the previous treatment. The financial statement impact of this change is reductions to balances of deferred revenue and increases in contract asset balances reported in other non-current assets.

Additionally, prior to the adoption of Topic 606, the Company recognized revenue from implementation services fees that are paid in advance in the Employer segment either when the associated software services are made available to the customer or over the customer relationship period. Under the new standard, revenue from these fees are recognized as the services are provided on a percentage of completion basis. The financial statement impact of this change is revenue from these fees being recognized sooner under the new standard.

In connection with the adoption of Topic 606, the Company is required to capitalize costs associated with obtaining and fulfilling a contract. Contract assets recognized for costs to obtain a contract consist primarily of sales commissions associated with obtaining contracts in the Carrier segment. These assets are amortized to sales and marketing expense over the estimated period of benefit of the asset, which is generally four to five years. Contract assets recognized for costs to fulfill a contract consist primarily of internal costs related to implementing products in the Carrier segment. These assets are amortized to cost of revenue expense over the estimated period of benefit, which is generally five years.

The Company used the practical expedient for contracts that were completed by January 1, 2018, the initial date of application of Topic 606, that allows for the use of the transaction price at the date the contract was completed for contracts restated in comparative reporting periods, rather than estimating the variable consideration amount in each comparative reporting period.

The following tables show the amounts by which financial statement lines were affected by the adoption of Topic 606.

Financial Statement Line Item	As of December 31, 2017		
	As previously reported	Adjustments	As adjusted
Consolidated Balance Sheet:			
Accounts receivable, net	\$30,156	\$ (65)	\$30,091
Contract, prepaid and other current assets	4,337	11,522	15,859
Deferred contract costs and other non-current assets	816	15,437	16,253
Accrued expenses	9,136	(26)	9,110
Deferred revenue, current portion	38,821	4,983	43,804
Deferred revenue, net of current portion	19,898	(8,675)	11,223
Additional paid-in capital	355,301	(2,805)	352,496
Accumulated deficit	(394,663)	33,417	(361,246)

Financial Statement Line Item	Three Months Ended September 30, 2017		
	As previously reported	Adjustments	As adjusted
Consolidated Statement of Operations and Comprehensive Loss:			
Revenue	\$62,453	\$ (6,202)	\$56,251
Cost of revenue	30,467	843	31,310
Sales and marketing	16,180	287	16,467
Loss from operations	(3,615)	(7,332)	(10,947)
Net loss and comprehensive loss	(6,674)	(7,332)	(14,006)

Edgar Filing: Benefitfocus, Inc. - Form 10-Q

Net loss per common share: Basic and diluted	\$ (0.21)	\$ (0.24)	\$ (0.45)
--	------------	------------	------------

Financial Statement Line Item	Nine Months Ended September 30, 2017		
	As previously reported	Adjustments	As adjusted
Consolidated Statement of Operations and Comprehensive Loss:			
Revenue	\$ 189,972	\$ (21,009)	\$ 168,963
Cost of revenue	90,896	2,312	93,208
Sales and marketing	51,103	1,250	52,353
Loss from operations	(9,736)	(24,571)	(34,307)
Net loss and comprehensive loss	(18,868)	(24,571)	(43,439)
Net loss per common share: Basic and diluted	\$ (0.61)	\$ (0.79)	\$ (1.40)

Cash provided by, or used in, operating, investing and financing activities were not affected by the adoption of Topic 606.

Accounting Standards Not Yet Adopted

In August 2018, the FASB issued ASU 2018-13, “Fair Value Measurement (Topic 820): Disclosure Framework - Changes to the Disclosure Requirements for Fair Value Measurement.” The ASU modifies the disclosure requirements required for fair value measurements. This ASU is effective for the Company for the interim and annual reporting periods starting January 1, 2020. Early adoption is permitted. The Company does not expect this guidance to have a material impact 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)” and subsequent related updates. The guidance requires 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 continuing to evaluate the impact of this guidance on its consolidated financial statements.

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	
	September 30,		September 30,	
Anti-Dilutive Common Share Equivalents	2018	2017	2018	2017
Restricted stock units	2,158,468	1,981,488	2,158,468	1,981,488
Stock options	248,097	281,840	248,097	281,840
Employee Stock Purchase Plan	2,480	3,566	2,480	3,566
Total anti-dilutive common share equivalents	2,409,045	2,266,894	2,409,045	2,266,894

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

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2018	2017	2018	2017
Numerator:				
Net loss	\$ (11,598)	\$ (14,006)	\$ (39,661)	\$ (43,439)

Edgar Filing: Benefitfocus, Inc. - Form 10-Q

Net loss attributable to common stockholders	\$ (11,598)	\$ (14,006)	\$ (39,661)	\$ (43,439)
Denominator:				
Weighted-average common shares outstanding, basic and diluted	31,883,029	31,181,141	31,678,360	30,974,116
Net loss per common share, basic and diluted	\$ (0.36)	\$ (0.45)	\$ (1.25)	\$ (1.40)

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.

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, 2018			
	Level		Level	
	Level 1	2	3	Total
Cash Equivalents:				
Money market mutual funds (1)	\$43,853	\$ —	\$ —	\$43,853
Total assets	\$43,853	\$ —	\$ —	\$43,853

Description	December 31, 2017			
	Level		Level	
	Level 1	2	3	Total
Cash Equivalents:				
Money market mutual funds (1)	\$46,730	\$ —	\$ —	\$46,730
Total assets	\$46,730	\$ —	\$ —	\$46,730

(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. Revolving Line of Credit

On March 29, 2018, the Company amended its revolving line of credit agreement. The amendment altered definitions in the revolving line of credit agreement, including Consolidated EBITDA and Recurring Revenue, and changes the Minimum Consolidated EBITDA requirements. The amendment was entered into to modify the above terms and requirements to account for the Company's adoption of Topic 606.

As of September 30, 2018 and December 31, 2017, the amount outstanding under the Company's revolving line of credit was \$69,246 and \$56,246, respectively. As of September 30, 2018, the additional amount available to borrow, adjusted by the borrowing base limit, was \$4,701 and the interest rate was 6.50%.

During the nine months ended September 30, 2018, the Company repaid \$84,000 of amounts outstanding under its line of credit and borrowed \$97,000 under its revolving line of credit for general operating purposes.

6. Stock-based Compensation

Restricted Stock Units

During the nine months ended September 30, 2018, the Company granted 660,642 restricted stock units, or RSUs, to employees and officers with an aggregate grant date fair value of \$18,380. These RSUs generally vest in equal annual installments over various periods ranging from less than 1 to 4 years from the grant date, subject to continued service to the Company. The Company amortizes the grant date fair value of the stock subject to the RSUs on a straight-line basis over the period of vesting.

During the nine months ended September 30, 2018, in connection with the Company's incentive bonus programs, the Company granted 856,236 performance RSUs to officers with an aggregate grant date fair value of \$20,661. The aggregate grant date fair value of the performance RSUs assuming target achievement was \$14,470. Vesting of the performance RSUs is contingent upon meeting specific financial, revenue and sales related growth targets through December 31, 2018. The actual number of shares issued upon vesting of the performance RSUs could range from 0% to 100% of the number granted. If any targets are met, the awards will vest in equal annual installments over 4 years starting April 1, 2019, except for 86,487 performance RSUs, which will vest in the first quarter of 2019, in each case subject to continued service to the Company. The Company amortizes the grant date fair value of the awards on an accelerated basis over the vesting period.

7. 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 September 30, 2018, the Company had reserved a total of 4,380,003 of its authorized 50,000,000 shares of common stock for future issuance as follows:

Outstanding stock options	248,097
Restricted stock units	2,158,468
Available for future issuance under stock award plans	1,846,700
Available for future issuance under ESPP	126,738
Total common shares reserved for future issuance	4,380,003

8. Revenue

Disaggregation of Revenue

The following tables provide information about disaggregation of revenue by service line and includes a reconciliation of disaggregated revenue with reportable segments:

	Three Months Ended September 30, 2018			Three Months Ended September 30, 2017		
	Employer	Carrier	Total	Employer	Carrier	Total
Service line:						
Software services	\$28,729	\$18,129	\$46,858	\$26,016	\$16,301	\$42,317
Professional services	9,279	4,869	14,148	10,935	2,999	13,934
Total	\$38,008	\$22,998	\$61,006	\$36,951	\$19,300	\$56,251

	Nine Months Ended September 30, 2018			Nine Months Ended September 30, 2017		
	Employer	Carrier	Total	Employer	Carrier	Total
Service line:						
Software services	\$89,705	\$53,611	\$143,316	\$80,273	\$51,109	\$131,382
Professional services	27,985	12,649	40,634	26,244	11,337	37,581
Total	\$117,690	\$66,260	\$183,950	\$106,517	\$62,446	\$168,963

Contract Balances

The following table provides information about contract assets and contract liabilities from contracts with customers:

	Balance at Beginning of Period	Balance at End of Period
Nine Months Ended September 30, 2018		
Contract assets	\$ 11,522	\$4,911
Contract liabilities:		
Deferred revenue	\$ 55,027	\$47,584
Nine Months Ended September 30, 2017		
Contract assets	\$ 15,929	\$5,400

Contract liabilities:

Deferred revenue	\$ 56,949	\$55,140
------------------	-----------	----------

The Company recognizes payments from customers based on contractual billing schedules. Accounts receivable are recorded when the right to consideration becomes unconditional. Contract assets include amounts related to the Company's contractual right to consideration for completed performance objectives not yet invoiced. Contract liabilities include payments received in advance of performance under the contract and are recognized as revenue when earned under the contract. The Company had no asset impairment charges related to contract assets during the three or nine months ended September 30, 2018 and 2017.

The following tables show the significant changes in contract asset balances:

	Three Months Ended September 30,	
Contract Assets	2018	2017
Transferred to receivables from contract assets	\$5,147	\$4,736
Revenue recognized from performance obligations satisfied but not billed	\$3,034	\$1,022

	Nine Months Ended September 30,	
Contract Assets	2018	2017
Transferred to receivables from contract assets	\$ 14,535	\$ 14,728
Revenue recognized from performance obligations satisfied but not billed	\$ 7,924	\$ 4,199

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 periods was \$11,929 and \$24,106, respectively.

The Company recorded cumulative catch-up adjustments to revenue arising from changes in estimates of transaction price of unfavorable \$(678) and favorable \$1,433 during the three and nine months ended September 30, 2018, respectively.

Performance Obligations

As of September 30, 2018, the aggregate amount of the Company's performance obligations that are unsatisfied or partially unsatisfied were approximately \$200,000, of which a majority are expected to be satisfied within the next three years. The Company excludes from its population of performance obligations contracts with original durations of one year or less, contract renewal periods that renew automatically, and amounts of variable consideration that are allocated to wholly unsatisfied distinct service that forms part of a single performance obligation and meets certain variable allocation criteria.

9. Income Taxes

The Company's effective federal tax rate for the three and nine months ended September 30, 2018 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.

During the three months ended September 30, 2018, the Company completed its accounting for the income tax effects of the December 22, 2017 enactment of the Tax Cuts & Jobs Act.

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 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.

Edgar Filing: Benefitfocus, Inc. - Form 10-Q

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, 2018	September 30, 2017	September 30, 2018	September 30, 2017
Revenue from external customers by segment:				
Employer	\$38,008	\$36,951	\$117,690	\$106,517
Carrier	22,998	19,300	66,260	62,446
Total net revenue from external customers	\$61,006	\$56,251	\$183,950	\$168,963
Depreciation and amortization by segment:				
Employer	\$2,473	\$2,519	\$7,620	\$7,490
Carrier	1,482	1,384	4,292	4,358
Total depreciation and amortization	\$3,955	\$3,903	\$11,912	\$11,848
Gross profit by segment:				
Employer	\$14,960	\$13,373	\$49,453	\$36,983
Carrier	14,306	11,568	40,633	38,772
Total gross profit	\$29,266	\$24,941	\$90,086	\$75,755

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 affiliated with an executive who is also a Company director and significant stockholder. Two of the Company's headquarter campus building leases 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 \$2,445 and \$2,374 for the three months ended September 30, 2018 and 2017, respectively, and \$8,197 and \$7,938 for the nine months ended September 30, 2018 and 2017, respectively. Other amounts due to these related parties were \$709 and \$901 as of September 30, 2018 and December 31, 2017, respectively, and were recorded in "Accrued expenses."

In March 2018, the Company's landlord extended the time period to commence construction of additional office space under its December 12, 2016 lease. Under the extension, the Company agrees to commence construction on or about April 1, 2019 and the target commencement date extends one year to July 1, 2020. The Company can terminate the lease prior to April 1, 2019.

Other Related Party Expenses

The Company utilizes the services of various companies that are owned and controlled by an executive who is also a Company director and significant stockholder. The companies provide construction project management services, private air transportation and other services. Expenses related to these companies were \$22 for the three months ended September 30, 2018, and \$46 and \$19 for the nine months ended September 30, 2018 and 2017, respectively. There were no expenses related to these companies for the three months ended September 30, 2017. There were no amounts due to these companies as of September 30, 2018 or December 31, 2017.

During the three months ended September 30, 2018, the Company entered into an agreement to purchase software and services from a company affiliated with a Company director. The aggregate amount of payments due under this contract is \$115. There were no payments related to this agreement for the three and nine months ended September 30, 2018. Amounts due to this company were \$35 as of September 30, 2018.

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 11.7% of the Company's outstanding common stock as of September 30, 2018. 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 \$7,271 of the \$69,246 outstanding under the revolving line of credit as of September 30, 2018 and \$5,906 of the \$56,246 outstanding under the revolving line of credit as of December 31, 2017.

12. Subsequent Events

Restricted Stock Units

On October 1, 2018, the Company granted 32,099 RSUs and 1,549 performance RSUs with an aggregate grant date fair value of \$1,222 and \$59, respectively. The aggregate grant date fair value of the performance RSUs assuming

target achievement was \$42. The RSUs generally vest in equal annual installments over four years from the grant date. The number of performance RSUs that will vest will be determined upon the achievement of certain financial targets for 2018, and vesting will then occur in equal annual installments over various periods ranging from less than one to four years. The actual number of shares issued upon vesting could range between 0% and 100% of the number of awards granted.

Common Stock

During October 2018, employees exercised stock options and RSUs vested resulting in the issuance of 60,587 shares.

Revolving Line of Credit

In October 2018, the Company repaid \$30,000 of the amount outstanding under its revolving line of credit and borrowed \$8,000 under its revolving line of credit for general operating purposes. In November 2018, the Company repaid \$8,000 of the amount outstanding 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, as amended, for the fiscal year ended December 31, 2017. 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 an expanding list of voluntary benefits offerings such as financial services, identity protection, pharmacy, and digital health. 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. 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 multi-year contracts with employer and insurance carrier customers, with subscription fees paid monthly, quarterly, or 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 contracts without cause or for convenience. Software services revenue accounted for approximately 77% and 75% of our total revenue during the three-month periods ended September 30, 2018 and 2017, and 78% of our total revenue during the each of the nine-month periods ended September 30, 2018 and 2017.

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 six 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 23% and 25% of our total revenue during the three-month periods ended September 30, 2018 and 2017, and 22% of our total revenue during each of the nine-month periods September 30, 2018 and 2017.

We believe that there is a substantial market for our services, and we have been investing in growth over the past six 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 a history of operating losses, 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.

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, 2018 and 2017, our software services revenue retention rate exceeded 95%.

Adjusted EBITDA

Adjusted EBITDA represents our earnings before net interest and other expenses, taxes, and depreciation and amortization expense, adjusted to eliminate stock-based compensation and impairment of goodwill and intangible assets and costs not core to our business. Beginning with the second quarter of 2018 and to align with other non-GAAP financial metrics that we report from time to time, we revised our definition of adjusted EBITDA to exclude costs incurred in connection with stock offerings that are expensed. This definition has been applied retrospectively to all periods presented. 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;
- 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, 2018	2017	September 30, 2018	2017
Reconciliation from Net Loss to Adjusted EBITDA:				

Edgar Filing: Benefitfocus, Inc. - Form 10-Q

Net loss	\$(11,598)	\$(14,006)	\$(39,661)	\$(43,439)
Depreciation	2,888	3,054	8,864	9,246
Amortization of software development costs	1,045	784	2,898	2,408
Amortization of acquired intangible assets	22	65	150	194
Interest income	(73)	(55)	(199)	(129)
Interest expense on building lease financing obligations	1,868	1,864	5,601	5,585
Interest expense on other borrowings	1,458	1,254	4,190	3,526
Income tax expense	13	5	22	10
Stock-based compensation expense	3,347	4,396	12,346	11,646
Transaction costs expensed	-	-	257	-
Costs not core to our business	1,027	359	3,922	480
Total net adjustments	11,595	11,726	38,051	32,966
Adjusted EBITDA	\$(3)	\$(2,280)	\$(1,610)	\$(10,473)

Number of Large Employer and Carrier Customers

We have aggressively invested in and intend to continue to invest in our sales function 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, 2018 2017	
Number of customers:		
Large employer	1,013	903
Carrier	56	54

While we have increased our net addition of large employer customers by 33% this year, we are actively shifting to new life-based metric in 2019, as indicated in our last quarterly earnings call. However, for the remainder of 2018, we plan to continue to provide the number of large employer and carrier customers as a measurement. We plan to stop providing customer count in 2019 and plan to introduce a new metric.

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, support 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, 2018 2017		September 30, 2018 2017	
Software services	\$46,858	\$42,317	\$143,316	\$131,382
Professional services	14,148	13,934	40,634	37,581
Total revenue	\$61,006	\$56,251	\$183,950	\$168,963

We recognize revenues when control of these services is transferred to customers, in an amount that reflects the consideration we expect to be entitled to in exchange for those services. Taxes collected from customers relating to services and remitted to governmental authorities are excluded from revenues.

We determine revenue recognition through the following steps:

- Identification of each contract with a customer;
- Identification of the performance obligations in the contract;
- Determination of the transaction price;
- Allocation of the transaction price to the performance obligations in the contract; and
- Recognition of revenue when, or as, performance obligations are satisfied.

Software Services Revenues

Software services revenues primarily consist of monthly subscription fees paid to us by our employer and insurance carrier customers for access to, and usage of, cloud-based benefits software solutions for a specified contract term. Fees are generally charged based on the number of employees or subscribers with access to the solution. Software services revenue also includes insurance broker commissions from the sale of voluntary and ancillary benefits policies to employees of our customers.

Software services revenues are generally recognized on a ratable basis over the contract term beginning on the date the software services are made available to the customer. Our software service contracts are generally three years for both carrier and employer customers. Revenue from insurance broker commissions is recognized when the orders for the policies are received and transferred to the insurance carrier, and is reduced by estimates for risk from premium collection, policy cancellation and termination.

Professional Services Revenues

Professional services revenues primarily consist of fees related to the implementation of software products purchased by customers. Professional services typically include discovery, configuration and deployment, integration, testing, and training. Fees from consulting services, support services and training are also included in professional services revenue.

Revenue from implementation services with customers in the Carrier segment are generally recognized over the contract term of the associated software services contract, including any extension periods representing a material right. We utilize estimates of hours as a measure of progress to determine revenue for certain types of arrangements.

Revenues from implementation services with customers in the Employer segment are generally recognized as those services are performed.

Revenues from support and training fees are recognized over the service contract period.

Contracts with Multiple Performance Obligations

Certain of our contracts with customers contain multiple performance obligations. For these contracts, the individual performance obligations are accounted for separately if they are distinct. The transaction price is allocated to the separate performance obligations based on their relative standalone selling prices. We determine the standalone selling prices based on its overall pricing objectives, taking into consideration market conditions and other factors, including the value of its contracts, the software services sold, customer size and complexity, and the number and types of users within the contracts.

Reclassifications

In conjunction with the adoption of the new revenue recognition accounting standard, we reclassified revenue and associated cost of revenue from support and video services from software services to professional services. This reclassification is reflected in all periods presented.

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 cost of revenue associated with fulfilling performance obligations as we incur the costs. Costs that relate directly to a customer contract that are not related to satisfying a performance obligation are capitalized and amortized to cost of revenue expense over the estimate period of benefit of the contract asset, which is generally five years.

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, if and 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. Costs to obtain a contract that are incremental, such as sales commissions, are capitalized and amortized to expense over the estimated period of benefit of the asset, which is generally four to five years. 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, if and as we achieve economies of scale.

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 adoption of new accounting standards.

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, 2018 and 2017.

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, 2018	September 30, 2017	September 30, 2018	September 30, 2017
Revenue	\$61,006	\$56,251	\$183,950	\$168,963
Cost of revenue ⁽¹⁾	31,740	31,310	93,864	93,208
Gross profit	29,266	24,941	90,086	75,755
Operating expenses:				
Sales and marketing ⁽¹⁾	17,661	16,467	55,978	52,353
Research and development ⁽¹⁾	10,676	12,568	34,827	37,222
General and administrative ⁽¹⁾	9,263	6,853	29,343	20,487
Total operating expenses	37,600	35,888	120,148	110,062
Loss from operations	(8,334)	(10,947)	(30,062)	(34,307)
Other expense:				

Edgar Filing: Benefitfocus, Inc. - Form 10-Q

Interest income	73	55	199	129
Interest expense on building lease financing obligations	(1,868)	(1,864)	(5,601)	(5,585)
Interest expense on other borrowings	(1,458)	(1,254)	(4,190)	(3,526)
Other income (expense)	2	9	15	(140)
Total other expense, net	(3,251)	(3,054)	(9,577)	(9,122)
Loss before income taxes	(11,585)	(14,001)	(39,639)	(43,429)
Income tax expense	13	5	22	10
Net loss	\$(11,598)	\$(14,006)	\$(39,661)	\$(43,439)

21

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

	Three Months Ended		Nine Months Ended	
	September 30, 2018	2017	September 30, 2018	2017
Cost of revenue	\$542	\$682	\$2,153	\$1,803
Sales and marketing	759	1,319	2,970	3,575
Research and development	494	743	2,103	2,200
General and administrative	1,552	1,652	5,120	4,068

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, 2018	2017	September 30, 2018	2017
Revenue	100.0 %	100.0 %	100.0 %	100.0 %
Cost of revenue	52.0	55.7	51.0	55.2
Gross profit	48.0	44.3	49.0	44.8
Operating expenses:				
Sales and marketing	28.9	29.3	30.4	31.0
Research and development	17.5	22.3	18.9	22.0
General and administrative	15.2	12.2	16.0	12.1
Total operating expenses	61.6	63.8	65.3	65.1
Loss from operations	(13.7)	(19.5)	(16.3)	(20.3)
Other expense:				
Interest income	0.1	0.1	0.1	0.1
Interest expense on building lease financing obligations	(3.1)	(3.3)	(3.0)	(3.3)
Interest expense on other borrowings	(2.4)	(2.2)	(2.3)	(2.1)
Other income (expense)	-	-	-	(0.1)
Total other expense, net	(5.3)	(5.4)	(5.2)	(5.4)
Loss before income taxes	(19.0)	(24.9)	(21.5)	(25.7)
Income tax expense	-	-	-	-
Net loss	(19.0)%	(24.9)%	(21.6)%	(25.7)%

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, 2018	2017	September 30, 2018	2017
Revenue from external customers by segment:				
Employer	\$38,008	\$36,951	\$117,690	\$106,517

Edgar Filing: Benefitfocus, Inc. - Form 10-Q

Carrier	22,998	19,300	66,260	62,446
Total net revenue from external customers	\$61,006	\$56,251	\$183,950	\$168,963
Gross profit by segment:				
Employer	\$14,960	\$13,373	\$49,453	\$36,983
Carrier	14,306	11,568	40,633	38,772
Total gross profit	\$29,266	\$24,941	\$90,086	\$75,755

Edgar Filing: Benefitfocus, Inc. - Form 10-Q

Comparison of Three Months Ended September 30, 2018 and 2017

Revenue

	Three Months Ended September 30, 2018		2017					
	Amount	Percentage of Revenue	Amount	Percentage of Revenue	Period-to-Period Change			
	(in thousands)				Amount	Percentage		
Software services	\$46,858	76.8	% \$42,317	75.2	% \$4,541	10.7	%	
Professional services	14,148	23.2	13,934	24.8	214	1.5		
Total revenue	\$61,006	100.0	% \$56,251	100.0	% \$4,755	8.5	%	

Growth in software services revenue in absolute terms was primarily attributable to a net increase in software subscription revenue of \$3.5 million as a result of existing customers adding covered users to our offerings, which we call volume increases, and also to existing customers purchasing additional products, as well as contractual price increases. Additionally, broker commission revenue increased \$0.8 million from enrollments in the quarter.

The increase in professional services revenue was attributable to an increase in customer-specific enhancements, primarily in the carrier segment, partially offset by decreases in implementation revenue and non-recurring consulting services.

Segment Revenue

	Three Months Ended September 30, 2018		2017					
	Amount	Percentage of Revenue	Amount	Percentage of Revenue	Period-to-Period Change			
	(in thousands)				Amount	Percentage		
Employer	\$38,008	62.3	% \$36,951	65.7	% \$1,057	2.9	%	
Carrier	22,998	37.7	19,300	34.3	3,698	19.2		
Total revenue	\$61,006	100.0	% \$56,251	100.0	% \$4,755	8.5	%	

Growth in our employer revenue was primarily attributable to a \$2.7 million increase in our employer software services revenue, driven by a \$1.9 million net increase in software subscription services revenue and \$0.8 million net increase in broker commission revenue. Employer professional services revenue decreased \$1.7 million as decreases in non-recurring consulting revenue were partially offset by an increase in support revenue from newly activated customers.

The increase in carrier revenue in absolute terms was comprised of an increase in software subscription revenue of \$1.5 million and increase in customer-specific enhancements of \$1.7 million.

Cost of Revenue

	Three Months Ended September 30, 2018		2017					
	Amount	Percentage of Revenue	Amount	Percentage of Revenue	Period-to-Period Change			
	(in thousands)				Amount	Percentage		
Cost of revenue	\$31,740	52.0	% \$31,310	55.7	% \$430	1.4	%	

The increase in cost of revenue in absolute terms was primarily attributable to an increase in salaries and other personnel-related costs. Cost of revenue decreased as a percentage of revenue as we continued to achieve economies of scale.

Gross Profit

	Three Months Ended September 30, 2018			2017			Period-to-Period Change		
	Amount (in thousands)	Percentage of Revenue		Amount	Percentage of Revenue		Amount	Percentage	
Software services	\$30,536	65.2	%	\$27,154	64.2	%	\$3,382	12.5	%
Professional services	(1,270)	(9.0	)	(2,213)	(15.9	)	943	(42.6	)
Gross profit	\$29,266	48.0	%	\$24,941	44.3	%	\$4,325	17.3	%

The increase in software services gross profit was driven by a \$4.5 million, or 10.7%, increase in software services revenue, only partially offset by an increase of \$1.2 million in software services cost of revenue as we continued to achieve economies of scale. Software services cost of revenue included \$0.3 million and \$0.4 million of stock-based compensation expense for the three-month periods ended September 30, 2018 and 2017, respectively, and \$2.6 million and \$2.3 million of depreciation and amortization for the three months ended September 30, 2018 and 2017, respectively.

Edgar Filing: Benefitfocus, Inc. - Form 10-Q

The improvement in professional services gross loss was driven by an increase in professional services revenue of \$0.2 million and a decrease in professional services cost of revenue of \$0.7 million. Professional services cost of revenue included \$0.2 million and \$0.3 million of stock-based compensation expense for the three months ended September 30, 2018 and 2017, respectively. In addition, professional services cost of revenue included \$0.5 million in depreciation and amortization in each of the three-month periods ended September 30, 2018 and 2017.

Segment Gross Profit

	Three Months Ended September 30, 2018		2017		Period-to-Period Change		
	Amount (in thousands)	Percentage of Revenue	Amount	Percentage of Revenue	Amount		Percentage
Employer	\$ 14,960	39.4 %	\$ 13,373	36.2 %	\$ 1,587	11.9 %	
Carrier	14,306	62.2 %	11,568	59.9 %	2,738	23.7 %	
Gross profit	\$29,266	48.0 %	\$24,941	44.3 %	\$ 4,325	17.3 %	

The increase in employer gross profit was driven by a \$1.1 million increase in employer revenue and a \$0.5 million decrease in employer cost of revenue as we continued to achieve economies of scale. Our employer cost of revenue included \$0.4 million and \$0.5 million of stock-based compensation expense for the three months ended September 30, 2018 and 2017, respectively. In addition, our employer cost of revenue included \$1.8 million of depreciation and amortization in each of the three-month periods ended September 30, 2018 and 2017.

The increase in carrier gross profit was comprised of a \$3.7 million increase in carrier revenue, partially offset by a \$1.0 million increase in carrier cost of revenue. Our carrier cost of revenue included \$0.2 million of stock-based compensation expense in each of the three-month periods ended September 30, 2018 and 2017. In addition, carrier cost of revenue included \$1.2 million and \$1.1 in depreciation and amortization for the three months ended September 30, 2018 and 2017, respectively.

Operating Expenses

	Three Months Ended September 30, 2018		2017		Period-to-Period Change		
	Amount (in thousands)	Percentage of Revenue	Amount	Percentage of Revenue	Amount		Percentage
Sales and marketing	\$17,661	28.9 %	\$16,467	29.3 %	\$ 1,194	7.3 %	
Research and development	10,676	17.5 %	12,568	22.3 %	(1,892)	(15.1 %)	
General and administrative	9,263	15.2 %	6,853	12.2 %	2,410	35.2 %	

The increase in sales and marketing expense was primarily attributable to a \$1.1 million increase in salaries and personnel-related costs due to hires of sales and marketing associates, and included a decrease in stock-based compensation of \$0.6 million. As discussed above in “Components of Operating Results-Operating Expenses”, certain sales commissions are capitalized and amortized over a period generally equal to four to five years.

The decrease in research and development expense reflects continued cost efficiencies during 2018 as salaries and personnel-related costs decreased by \$0.6 million and contracted services decreased by \$0.6 million. An additional decrease of \$0.5 million is attributable to an increase in the amount of software development cost capitalized.

The increase in general and administrative expense included an increase in salary and personnel-related costs of \$1.1 million, net of a decrease in stock-based compensation of \$0.1 million. The remaining increase was primarily

attributable to professional fees incurred in connection with implementing the new accounting standards, as well as costs associated with preparing for our first year of Sarbanes-Oxley 404(b) audit requirements.

Edgar Filing: Benefitfocus, Inc. - Form 10-Q

Comparison of Nine Months Ended September 30, 2018 and 2017

Revenue

	Nine Months Ended September 30, 2018		2017		Period-to-Period Change		
	Amount	Percentage of Revenue	Amount	Percentage of Revenue	Amount	Percentage	
	(in thousands)						
Software services	\$143,316	77.9	% \$131,382	77.8	% \$11,934	9.1	%
Professional services	40,634	22.1	37,581	22.2	3,053	8.1	
Total revenue	\$183,950	100.0	% \$168,963	100.0	% \$14,987	8.9	%

Growth in software services revenue was primarily attributable to an increase in software subscription revenue of \$9.0 million as a result of volume increases, and also to existing customers purchasing additional products, as well as to the net addition of new customers. Software subscription revenue included an increase of \$1.1 million related to a change in estimated revenue from an employer customer contract. Additionally, new insurance broker commissions from enrollments in 2018 contributed an increase of \$1.8 million.

The increase in professional services revenue was attributable to an increase in support revenue from newly activated customers of \$2.3 million, and an increase in customer-specific enhancements of \$2.9 million. These increases were partially offset by decreases in carrier implementation revenue of \$1.0 million and non-recurring consulting revenue of \$1.4 million.

Segment Revenue

	Nine Months Ended September 30, 2018		2017		Period-to-Period Change		
	Amount	Percentage of Revenue	Amount	Percentage of Revenue	Amount	Percentage	
	(in thousands)						
Employer	\$117,690	64.0	% \$106,517	63.0	% \$11,173	10.5	%
Carrier	66,260	36.0	62,446	37.0	3,814	6.1	
Total revenue	\$183,950	100.0	% \$168,963	100.0	% \$14,987	8.9	%

Growth in our employer revenue was primarily attributable to a \$9.4 million increase in our employer software services revenue, driven primarily by an increase in software subscription revenue of \$6.2 million as well as an increase in new insurance broker commissions from enrollments in 2018 of \$1.8 million, and a favorable decline in the sales returns and allowance of \$1.1 million. Additionally, employer professional services revenue increased \$1.7 million primarily from an increase in support revenue and an increase in implementation revenue, partially offset by decreases in non-recurring consulting revenue.

The increase in carrier revenue was primarily attributable to net volume and contractual increases in software services revenue as well as increases in customer-specific enhancement revenue from professional services. These increases were partially offset by a decrease in implementation professional services revenue.

Cost of Revenue

	Nine Months Ended September 30, 2018		2017	
	Percentage of		Percentage of	

	Amount		Revenue		Amount		Revenue		Period-to-Period Change	
									Amount	Percentage
	(in thousands)									
Cost of revenue	\$93,864	51.0	%	\$93,208	55.2	%	\$ 656	0.7	%	

The increase in cost of revenue in absolute terms was primarily attributable to an increase in salaries and other personnel-related costs, including an increase of \$0.3 million in stock-based compensation expense. This increase was partially offset by lower third-party costs. Cost of revenue decreased as a percentage of revenue as we continued to achieve economies of scale.

Gross Profit

	Nine Months Ended September 30,							
	2018		2017				Period-to-Period Change	
	Amount	Percentage of Revenue	Amount	Percentage of Revenue	Amount	Percentage of Revenue	Amount	Percentage
	(in thousands)							
Software services	\$94,492	65.9	%	\$84,420	64.3	%	\$10,072	11.9
Professional services	(4,406)	(10.8)		(8,665)	(23.1)		4,259	(49.2)
Gross profit	\$90,086	49.0	%	\$75,755	44.8	%	\$14,331	18.9

Edgar Filing: Benefitfocus, Inc. - Form 10-Q

The increase in software services gross profit was driven by a \$11.9 million, or 9.1%, increase in software services revenue only partially offset by an increase of \$1.9 million in software services cost of revenue as we continued to achieve economies of scale. Software services cost of revenue included \$1.2 million and \$0.9 million of stock-based compensation expense for the nine months ended September 30, 2018 and 2017, respectively, and \$7.5 million and \$7.2 million of depreciation and amortization for the nine months ended September 30, 2018 and 2017, respectively.

The improvement in professional services gross loss was driven by an increase in professional services revenue of \$3.1 million, or 8.1% and a decrease in professional services cost of revenue of \$1.2 million. Professional services cost of revenue included \$0.9 million of stock-based compensation expense for each of the nine-month periods ended September 30, 2018 and 2017, and \$1.4 million and \$1.6 million in depreciation and amortization for the nine months ended September 30, 2018 and 2017, respectively.

Segment Gross Profit

	Nine Months Ended September 30, 2018			2017			Period-to-Period Change	
	Amount (in thousands)	Percentage of Revenue		Amount	Percentage of Revenue		Amount	Percentage
Employer	\$49,453	42.0	%	\$36,983	34.7	%	\$12,470	33.7
Carrier	40,633	61.3		38,772	62.1		1,861	4.8
Gross profit	\$90,086	49.0	%	\$75,755	44.8	%	\$14,331	18.9

The increase in employer gross profit was driven by a \$11.2 million, or 10.5%, increase in employer revenue and a \$1.3 million decrease in employer cost of revenue as we continued to achieve economies of scale. The decrease in cost of revenue was primarily attributable to decreased third-party costs. Our employer cost of revenue included \$1.6 million and \$1.4 million of stock-based compensation expense for the nine months ended September 30, 2018 and 2017, respectively. In addition, our employer cost of revenue included \$5.5 million and \$5.4 million of depreciation and amortization for the nine months ended September 30, 2018 and 2017, respectively.

The carrier gross profit was comprised of \$3.8 million increase in carrier revenue offset by a \$2.0 million increase in carrier cost of revenue. Our carrier cost of revenue included \$0.6 million and \$0.4 million of stock-based compensation expense for the nine months ended September 30, 2018 and 2017, respectively. In addition, carrier cost of revenue included \$3.5 million and \$3.4 million in depreciation and amortization for the nine months ended September 30, 2018 and 2017, respectively.

Operating Expenses

	Nine Months Ended September 30, 2018			2017			Period-to-Period Change	
	Amount (in thousands)	Percentage of Revenue		Amount	Percentage of Revenue		Amount	Percentage
Sales and marketing	\$55,978	30.4	%	\$52,353	31.0	%	\$3,625	6.9
Research and development	34,827	18.9		37,222	22.0		(2,395)	(6.4)
General and administrative	29,343	16.0		20,487	12.1		8,856	43.2

The increase in sales and marketing expense was primarily attributable to a \$3.4 million increase in salaries and personnel-related costs due to hires of sales and marketing associates. Other changes in sales and marketing expense were an increase of \$0.3 million in travel-related costs and a decrease of \$1.0 million in marketing expense primarily driven by cost savings experienced in connection with our marketing events. As discussed above in "Components of

Operating Results-Operating Expenses”, certain sales commissions are capitalized and amortized over a period generally equal to four to five years.

The decrease in research and development expense reflects continued cost efficiencies during 2018 as salaries and personnel-related costs decreased by \$0.3 million and contracted services and professional fees decreased by \$1.1 million. An additional decrease of \$0.8 million is attributable to an increase in the amount of software development cost capitalized.

The increase in general and administrative expense included an increase in salary and personnel-related costs of \$4.1 million, including an increase in stock-based compensation of \$1.1 million. The remaining increase was primarily attributable to professional fees incurred in connection with implementing the new accounting standards and costs associated with preparing for our first year of Sarbanes-Oxley 404(b) audit requirements, as well as transaction costs expensed, primarily in connection with a secondary stock offering during the second quarter of 2018.

Critical Accounting Policies and Significant Judgments and Estimates

Our management’s discussion and analysis of our financial condition and results of operations is based on our consolidated financial statements, which have been prepared in accordance with GAAP. The preparation of these consolidated financial statements requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the consolidated financial statements, and the reported amounts of revenue and expenses. In accordance with GAAP, we base our estimates on historical experience and on various other assumptions that we believe are

reasonable under the circumstances. Actual results might differ from these estimates under different assumptions or conditions and, to the extent that there are differences between our estimates and actual results, our future financial statement presentation, financial condition, results of operations and cash flows will be affected. During the nine months ended September 30, 2018 there were no material changes to our critical accounting policies and use of estimates, which are disclosed in our Annual Report on Form 10-K for the year ended December 31, 2017, as amended, except for revenue recognition, which changed in connection with the adoption of Topic 606 and is described elsewhere in this report.

Liquidity and Capital Resources

Sources of Liquidity

As of September 30, 2018, our primary sources of liquidity were our cash and cash equivalents totaling \$51.1 million, \$27.6 million in accounts receivables, net of allowances, and the unused portion of our revolving line of credit. While the revolving line of credit provides for up to an additional \$25.8 million in borrowing, in fact, after taking into account the borrowing base limit the amount available to borrow under the revolving line of credit was \$4.7 million as of September 30, 2018.

We are bound by customary affirmative and negative covenants in connection with the revolving line of credit, including financial covenants related to liquidity and EBITDA. In the event of a default, the lenders may declare all obligations immediately due and stop advancing money or extending credit under the line of credit. The line of credit is collateralized by substantially all of our tangible and intangible assets, including intellectual property and the equity of our subsidiaries.

Based on our current level of operations and anticipated growth, we believe our future cash flows from operating activities and existing cash balances will be sufficient to meet our cash requirements for at least the next 12 months.

Going forward, we may access capital markets to raise additional equity or debt financing for various business reasons, including required debt payments and acquisitions. The timing, term, size, and pricing of any such financing will depend on investor interest and market conditions, and there can be no assurance that we will be able to obtain any such financing on favorable terms or at all.

Cash Flows

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

	Nine Months Ended September 30, 2018 2017 (in thousands)	
Cash (used in) provided by:		
Operating activities	\$(3,982)	\$(15,068)
Investing activities	(5,855)	(4,151)
Financing activities	5,567	16,939

Operating Activities

For the nine months ended September 30, 2018, our operating activities used \$4.0 million of cash, as our net loss of \$39.7 million was offset by \$30.3 million for non-cash adjustments and \$5.4 million of cash provided by changes in

working capital. Adjustments for non-cash items primarily consisted of non-cash stock compensation expense of \$12.3 million, depreciation and amortization expense of \$11.9 million, and accrual of interest on financing obligations of \$5.6 million. The cash provided by changes in working capital is primarily driven by decreases in accounts receivable, contract and other current and non-current assets and deferred costs, and increases in accounts payable and accrued expenses. These changes which provide cash were offset by decreases in deferred revenue and accrued compensation expenses.

For the nine months ended September 30, 2017, our operating activities used \$15.1 million of cash, as our net loss of \$43.4 million and \$1.0 million of cash used in changes in working capital was partially offset by \$29.4 million for non-cash adjustments. Adjustments for non-cash items primarily consisted of depreciation and amortization expense of \$11.8 million, non-cash stock compensation expense of \$11.6 million, and accrual of interest on financing obligations of \$5.6 million. The cash used in changes in working capital is primarily driven by increases in accounts receivable, decreases in deferred revenue and the timing of payments for accounts payable, accrued expenses and accrued compensation and benefits and deferred revenue, partially offset by decreases in contract, prepaid and other current and non-current assets and deferred contract costs.

Investing Activities

For the nine months ended September 30, 2018 and 2017, net cash used in investing activities was \$5.8 million and \$6.2 million, respectively, for the purchase of property and equipment. Additionally, during the nine months ended September 30, 2017, the maturity of short-term investments classified as held-to-maturity provided \$2.0 million.

Financing Activities

For the nine months ended September 30, 2018, net cash provided by financing activities was \$5.6 million, consisting primarily of net draws on the revolving line of credit of \$13.0 million and \$0.5 million from stock option exercises and employee stock purchase program. These were partially offset by payments of \$7.9 million of financing and capital lease obligations.

For the nine months ended September 30, 2017, net cash provided by financing activities was \$16.9 million, consisting primarily of net draws on the revolving line of credit of \$20.0 million and \$3.6 million from stock option exercises. These were partially offset by payments of \$6.6 million of financing and capital lease obligations.

Commitments

On March 29, 2018, we amended our revolving line of credit agreement. The amendment alters definitions in the revolving line of credit agreement, including Consolidated EBITDA and Recurring revenue, and changes the Minimum Consolidated EBITDA requirements. The amendment was entered into to modify the above terms and requirements to account for the Company's adoption Topic 606 for changes in revenue recognition.

Off-Balance Sheet Arrangements

As of September 30, 2018, we did not have any off-balance sheet arrangements, as defined in Item 303(a)(4)(ii) of Regulation S-K of the Securities Act, such as the use of unconsolidated subsidiaries, structured finance, special purpose entities or variable interest entities.

Recent Accounting Pronouncements

In June 2016, the FASB issued ASU No. 2016-13, "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 beginning after December 15, 2019. We are currently evaluating the impact of this guidance on our consolidated financial statements.

In February 2016, the FASB issued ASU No. 2016-02 "Leases (Topic 842)" and subsequent related updates. The guidance requires 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 us beginning January 1, 2019, but early adoption is permitted. We are continuing to evaluate the impact of this update on our consolidated financial statements.

We are evaluating other accounting standards and exposure drafts that have been issued or proposed by the FASB or other standards setting bodies that do not require adoption until a future date to determine whether adoption will have a material impact on our consolidated financial statements.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

Market risk is the risk of loss to future earnings, values or future cash flows that may result from changes in the price of a financial instrument. The value of a financial instrument might change as a result of changes in interest rates, exchange rates, commodity prices, equity prices and other market changes. We do not use derivative financial instruments for speculative, hedging or trading purposes, although in the future we might enter into exchange rate hedging arrangements to manage the risks described below.

Interest Rate Risk

We are exposed to market risk related to changes in interest rates. Borrowings under our revolving line of credit bear interest at rates that are variable. Increases in the Prime Rate would increase the revolving line of credit.

Interest Rate Sensitivity

We are subject to interest rate risk in connection with borrowings under the revolving line of credit, which are subject to a variable interest rate. At September 30, 2018, we had borrowings under the revolving line of credit of \$69.2 million. As a result, each change of one percentage point in interest rates would result in an approximate \$0.7 million change in our annual interest expense on our outstanding borrowings at September 30, 2018. Any debt we incur in the future may also bear interest at variable rates.

Inflation Risk

We do not believe that inflation has had a material effect on our business, financial condition, or results of operations. We continue to monitor the impact of inflation in order to minimize its effects through pricing strategies, productivity improvements and cost reductions. If our costs were to become subject to significant inflationary pressures, we may not be able to fully offset such higher costs through price increases. Our inability or failure to do so could harm our business, financial condition, and results of operations.

ITEM 4. CONTROLS AND PROCEDURES.

(a) Evaluation of Disclosure Controls and Procedures

Under the supervision and with the participation of our management, including our President and Chief Executive Officer and our Chief Financial Officer, we conducted an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act, as of the end of the period covered by this report.

In designing and evaluating our disclosure controls and procedures, management recognizes that any disclosure controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives. In addition, the design of disclosure controls and procedures must reflect the fact that there are resource constraints and that management is required to apply its judgment in evaluating the benefits of possible controls and procedures relative to their costs.

Based on their evaluation, our President and Chief Executive Officer and our Chief Financial Officer concluded that as of September 30, 2018 our disclosure controls and procedures were designed to, and were effective to, provide assurance at a reasonable level that the information we are required to disclose in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms, and that such information is accumulated and communicated to our management, including our President and Chief Executive Officer and our Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosures as of September 30, 2018.

(b) Changes in Internal Control Over Financial Reporting

No changes in internal control over financial reporting occurred during the most recent fiscal quarter with respect to our operations, which has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION.

Item 1A. RISK FACTORS.

Investing in our common stock involves a high degree of risk. You should consider carefully the risks and uncertainties described below, together with all of the other information in this Quarterly Report on Form 10-Q, including the consolidated financial statements and the related notes, before deciding to invest in shares of our common stock. If any of the following risks were to materialize, our business, financial condition, results of operations, and future growth prospects could be materially and adversely affected. In that event, the market price of our common stock could decline and you could lose part or all of your investment in our common stock.

Risks Related to Our Business

We have had a history of losses, and we might not be able to achieve or sustain profitability.

We have had a history of net losses, including a net loss of \$50.3 million for the year ended December 31, 2017 and net losses of \$39.7 million and \$43.4 million for the nine months ended September 30, 2018 and 2017, respectively. We cannot predict if we will achieve sustained profitability in the near future or at all. We expect to make significant future expenditures to develop and expand our business. In addition, as a public company, we incur significant legal, accounting, and other expenses that we would not incur as a private company. These expenditures make it harder for us to achieve and maintain future profitability. Our recent growth in revenue and number of customers might not be sustainable, and we might not achieve sufficient revenue to achieve or maintain profitability. We could incur significant losses in the future for a number of reasons, including the other risks described in this Quarterly Report on Form 10-Q, and we may encounter unforeseen expenses, difficulties, complications and delays and other unknown events. Accordingly, we might not be able to achieve or maintain profitability and we may incur significant losses for the foreseeable future.

Our quarterly operating results have fluctuated in the past and might continue to fluctuate, causing the value of our common stock to decline substantially.

Our quarterly operating results might fluctuate due to a variety of factors, many of which are outside of our control. As a result, comparing our operating results on a period-to-period basis might not be meaningful. You should not rely on our past results as indicative of our future performance. Moreover, our stock price might be based on expectations of future performance that are unrealistic or that we might not meet and, if our revenue or operating results fall below the expectations of investors or securities analysts, the price of our common stock could decline substantially. For example, on August 4, 2017, the first trading day after we publicly announced our operating results for the second quarter ended June 30, 2017, our stock price dropped \$7.10 per share, or approximately 20.5%, to \$27.50.

Our operating results have varied in the past. In addition to other risk factors listed in this section, some of the important factors that may cause fluctuations in our quarterly operating results include:

- our ability to hire and retain qualified personnel, including the rate of expansion of our sales force;
- the extent to which our products and services achieve or maintain market acceptance, including through brokers;

- changes in the regulatory environment related to benefits and healthcare;
- our ability to introduce new products and services and enhancements to our existing products and services on a timely basis;
- new competitors and the introduction of enhanced products and services from competitors;
- the financial condition of our current and potential customers;
- changes in customer budgets and procurement policies;
- the amount and timing of our investment in research and development activities;
- technical difficulties with our products or interruptions in our services;
- regulatory compliance costs;
- the timing, size, and integration success of potential future acquisitions; and
- unforeseen legal expenses, including litigation and settlement costs.

In addition, a significant portion of our operating expense is relatively fixed in nature, and planned expenditures are based in part on expectations regarding future revenue. Accordingly, unexpected revenue shortfalls might decrease our gross margins and could cause significant changes in our operating results from quarter to quarter. If this occurs, the trading price of our common stock could fall substantially, either suddenly or over time.

Because we recognize revenue and expense relating to monthly subscriptions and professional services over varying periods, downturns or upturns in sales are not immediately reflected in full in our operating results.

As a SaaS company, under Topic 606, we recognize our subscription revenue monthly for the term of our contracts and therefore a shortfall in demand for our software solutions and professional services or a decline in new or renewed contracts in any one quarter might not significantly reduce our revenue for that quarter, but could negatively affect our revenue in future quarters. Accordingly, the effect of significant downturns in new or renewed sales of our products and services might not be reflected in full in our results of operations until future periods.

Our revenue recognition model also makes it difficult for us to rapidly increase our revenue through additional sales in any period, because revenue from new customers has to be recognized over the applicable term of the contracts or the estimated expected life of the customer relationship period.

Changes in, or interpretations of, existing accounting principles, including regarding revenue recognition and accounting for leases, and their implementation could have an adverse impact on our reported financial results.

We prepare our financial statements in accordance with GAAP. These rules are subject to interpretation by the SEC and various bodies formed to interpret and create appropriate accounting principles. Changes in these rules or their interpretation could have a negative impact on our reported financial results and may retroactively affect previously reported transactions. For example, in May 2014, the Financial Accounting Standards Board, or FASB, issued an accounting standards update on revenue recognition, which supersedes nearly all existing revenue recognition guidance under GAAP. The new standard was effective for us beginning January 1, 2018. The adoption of the new revenue recognition guidance decreased our revenue and increased our net loss in 2017 compared to the previous guidance. The effects of the new accounting standard are described in Note 2 to our unaudited consolidated financial statements appearing elsewhere in this Quarterly Report on Form 10-Q.

In addition, in February 2016, FASB issued an accounting standards update on leases, requiring 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, which will be effective beginning January 1, 2019, also introduces new disclosure requirements for leasing arrangements. We are currently evaluating the impact of this update on the consolidated financial statements, which could be material, given our related party leases.

Implementation of these new standards, and any future accounting pronouncements, implementation guidelines, or interpretations, could have an adverse impact on our reported financial results, require that we make significant changes to our systems, processes and controls, or the way we conduct our business. In addition, we are expending considerable effort and resources preparing for and implementing both of these accounting updates, which in and of itself could have negative impact on our results of operations.

We depend on our senior management team, and the loss of one or more key associates or an inability to attract and retain highly skilled associates could adversely affect our business.

Our success depends largely upon the continued services of our key executive officers and other associates. We also rely on our leadership team in the areas of research and development, marketing, services, finance, and general and administrative functions, and on mission-critical individual contributors in sales and research and development. From time to time, there may be changes in our executive management team resulting from the hiring or departure of executives, which could disrupt our business. For example: in 2017, we hired a new Chief Financial Officer and an Executive Vice President of Global Sales; effective January 1, 2018, our Chief Executive Officer became Senior Advisor for Innovation, but remained on our Board of Directors, and our Chief Operating Officer became our Chief Executive Officer; and, in March 2018, our Senior Advisor for Innovation resigned from employment and our Board,

effective April 1, 2018, for personal reasons. The loss of one or more of our executive officers or key associates could have a serious adverse effect on our business.

To continue to execute our growth strategy, we also must attract and retain highly skilled personnel. Competition is intense for sales people and for engineers with high levels of experience in designing and developing software and Internet-related services. We might not be successful in maintaining our unique culture and continuing to attract and retain qualified personnel. We have from time to time in the past experienced, and we expect to continue to experience in the future, difficulty in hiring and retaining highly skilled personnel with appropriate qualifications. The pool of qualified personnel with SaaS experience and/or experience working with the benefits market is limited overall and specifically in Charleston, South Carolina, where our principal office is located. In addition, many of the companies with which we compete for experienced personnel have greater resources than we have and are located in geographic areas, like Silicon Valley, that may attract more qualified technology workers.

In addition, in making employment decisions, particularly in the Internet and high-technology industries, job candidates often consider the value of the equity awards they are to receive in connection with their employment. Volatility in the price of our stock might, therefore, adversely affect our ability to attract or retain highly skilled personnel. Furthermore, the requirement to expense certain stock awards might discourage us from granting the size or type of stock awards that job candidates require to join our company. If we fail to

attract new personnel or fail to retain and motivate our current personnel, our business and future growth prospects could be severely harmed.

We operate in a highly competitive industry, and if we are not able to compete effectively, our business and operating results will be harmed.

The benefits management software market is highly competitive and is likely to attract increased competition, which could make it hard for us to succeed. Small, specialized providers continue to become more sophisticated and effective. In addition, large, well-financed, and technologically sophisticated software companies might focus more on our market. The size and financial strength of these entities is increasing as a result of continued consolidation in both the IT and healthcare industries. We expect large integrated software companies to become more active in our market, both through acquisitions and internal investment. In addition, insurance carriers may seek to bring certain of their benefits software solutions in-house, whether through acquisitions or internal investment. For example, Aetna, a customer of ours, owns bswift, a provider of insurance exchange technology solutions and benefits administration technology solutions and services. If Aetna were to decide to use bswift's solution in place of any portion of the solutions we currently provide to them, then our business and operating results could be materially and adversely affected. As costs fall and technology improves, increased market saturation might change the competitive landscape in favor of our competitors.

Some of our current large competitors have greater name recognition, longer operating histories, and significantly greater resources than we do. As a result, our competitors might be able to respond more quickly and effectively than we can to new or changing opportunities, technologies, standards, or customer requirements. In addition, current and potential competitors have established, and might in the future establish, cooperative relationships with vendors of complementary products, technologies, or services to increase the availability of their products in the marketplace. Accordingly, new competitors or alliances might emerge that have greater market share, a larger customer base, more widely adopted proprietary technologies, greater marketing expertise, greater financial resources, and larger sales forces than we have, which could put us at a competitive disadvantage. Further, in light of these advantages, even if our products and services are more effective than those of our competitors, current or potential customers might accept competitive offerings in lieu of purchasing our offerings. Increased competition is likely to result in pricing pressures, which could negatively impact our sales, profitability, or market share. In addition to new niche vendors, who offer standalone products and services, we face competition from existing enterprise vendors, including those currently focused on software solutions that have information systems in place with potential customers in our target market. These existing enterprise vendors might promise products or services that offer ease of integration with existing systems and which leverage existing vendor relationships. In addition, large insurance carriers often have internal technology staffs and proprietary software for benefits management, making them less likely to buy our solutions.

The market for our products and services is immature and volatile, and if it does not develop or if it develops more slowly than we expect, the growth of our business will be harmed.

The cloud-based benefits management software market is relatively new and unproven, and it is uncertain whether it will achieve and sustain high levels of demand and market acceptance. Our success will depend to a substantial extent on the willingness of employers, carriers, and consumers to increase their use of benefits management software. Many employers and carriers have invested substantial personnel and financial resources to integrate internally developed solutions or traditional enterprise software into their businesses for benefits management, and therefore might be reluctant or unwilling to migrate to our cloud-based solutions. Furthermore, some businesses might be reluctant to use cloud-based solutions because they have concerns about the security of their data and the reliability of the technology delivery model associated with these solutions. If employers, carriers and consumers do not perceive the benefits of our solutions, then our market might not develop at all, or it might develop more slowly than we expect, either of which could significantly adversely affect our operating results. In addition, we might make errors in predicting and

reacting to relevant business trends, which could harm our business. If any of these risks occur, it could materially adversely affect our business, financial condition or results of operations.

The SaaS pricing model is evolving and our failure to manage its evolution and demand could lead to lower than expected revenue and profit.

We derive most of our revenue growth from subscription offerings and, specifically, SaaS offerings. This business model depends heavily on achieving economies of scale because the initial upfront investment is costly and the associated revenue is recognized on a ratable basis. If we fail to achieve appropriate economies of scale or if we fail to manage or anticipate the evolution and demand of the SaaS pricing model, then our business and operating results could be adversely affected.

If we do not continue to innovate and provide products and services that are useful to consumers, employers, insurance carriers, and brokers and provide high quality support services, we might not remain competitive, and our revenue and operating results could suffer.

Our success depends in part on providing products and services that consumers, employers, insurance carriers, and brokers will use to manage benefits. We must continue to invest significant resources in research and development in order to enhance our existing products and services and introduce new high quality products and services that customers will want. If we are unable to predict user preferences or industry changes, or if we are unable to modify our products and services on a timely basis, we might lose customers. Our operating results would also suffer if our innovations are not responsive to the needs of our customers, are not appropriately timed

with market opportunity, or are not effectively brought to market. As technology continues to develop, our competitors might be able to offer results that are, or that are perceived to be, substantially similar to or better than those generated by us. This would force us to compete on additional product and service attributes and to expend significant resources in order to remain competitive.

In addition, we may experience difficulties with software development, industry standards, design, or marketing that could delay or prevent our development, introduction, or implementation of new solutions and enhancements. The introduction of new solutions by competitors, the emergence of new industry standards, or the development of entirely new technologies to replace existing offerings could render our existing or future solutions obsolete.

Our success also depends on providing high quality support services to resolve any issues related to our products and services. High quality education and customer support is important for the successful marketing and sale of our products and services and for the renewal of existing customers. If we do not help our customers quickly resolve issues and provide effective ongoing support, our ability to sell additional products and services to existing customers would suffer and our reputation with existing or potential customers would be harmed.

If we are unable to retain our existing customers, our revenue and results of operations would be adversely affected.

We sell our products and services pursuant to agreements that are generally one year for employers and three to five years for carriers. While our employer contracts generally automatically renew on an annual basis, our carrier customers have no obligation to renew their contracts after their contract period expires, and these contracts might not be renewed on the same or on more profitable terms if at all. Additionally, some of our carrier customers are able to terminate their respective contracts without cause or for convenience, although generally our carrier contracts are only cancellable by the carrier in an instance of our uncured breach. As a result, our ability to grow depends in part on the continuance and renewal of our carrier contracts. We may not be able to accurately predict future trends in customer renewals, and our customers' renewal rates may decline or fluctuate because of several factors, including their level of satisfaction or dissatisfaction with our services, the cost of our services, the cost of services offered by our competitors, consolidations or reductions in our customers' spending levels. If our carrier customers terminate or do not renew their contracts for our services, renew on less favorable terms, or do not purchase additional functionality or products, our revenue may grow more slowly than expected or decline, and our profitability and gross margins may be harmed.

A significant amount of our revenue is derived from our largest customers, and any reduction in revenue from any of these customers would reduce our revenue and net income.

Our ten largest customers by revenue accounted for approximately 42% of our consolidated revenue in 2017 and 2016, respectively. Our largest customer by revenue accounted for approximately 11% and 12% of our revenue in each of 2017 and 2016, respectively. In addition, one customer represented 12% and 14% of our accounts receivable at December 31, 2017 and 2016, respectively and another represented 13% at December 31, 2016. If any of our large customers or strategic partners decides not to renew its contracts with us, or to renew on less favorable terms, our business, revenues, reputation, and our ability to obtain new customers could be materially and adversely affected.

Failure to adequately and effectively expand our direct sales force will impede our growth.

We believe that our future growth will depend on the development of our direct sales force and its ability to obtain new customers and to manage our existing customer base. Identifying and recruiting qualified personnel and training them in the use of our software requires significant time, expense, and attention. It can take six months or longer before a new sales representative is fully trained and productive. Our business may be adversely affected if our efforts to expand and train our direct sales force do not generate a corresponding increase in revenues. For example, reduction

of our sales force in 2016 negatively impacted sales, and as a result, revenue going forward. In particular, if we are unable to hire and develop sufficient numbers of productive direct sales personnel or if new direct sales personnel are unable to achieve desired productivity levels in a reasonable period of time, sales of our products and services will suffer and our growth will be impeded.

Our growth depends in part on the success of our strategic relationships with third parties, including brokers.

In order to grow our business, we anticipate that we will continue to depend on our relationships with third parties including resellers such as Mercer Health and Benefits LLC, or Mercer, and SAP SE, and other referral sources such as brokers, consultants, specialty benefits providers, insurance carriers, technology and content providers, and third-party system integrators. Identifying partners, negotiating and documenting relationships with them, and developing referral sources requires significant time and resources. Our expanded relationship with and February 2015 sale of stock to Mercer increases our reliance on it and related risks, including Mercer's competitors being less likely to do business with us. Our competitors might be effective in providing incentives to third parties to favor their products or services or to prevent or reduce subscriptions to our products and services. In addition, acquisitions of our partners by our competitors could result in a decrease in the number of our current and potential customers, as our partners may no longer facilitate the adoption of our applications by potential customers. If we are unsuccessful in establishing or maintaining our relationships with third parties, our ability to compete in the marketplace or to grow our revenue could be impaired and our operating results may suffer. Even if we are successful, we cannot assure you that these relationships will result in increased customer use of our applications or increased revenue.

If the number of individuals covered by our employer and carrier customers decreases or the number of products or services to which our employer and carrier customers subscribe decreases, our revenue will decrease.

Under most of our customer contracts, we base our fees on the number of individuals to whom our customers provide benefits and the number of products or services subscribed to by our customers. Many factors may lead to a decrease in the number of individuals covered by our customers and the number of products or services subscribed to by our customers, including:

- failure of our customers to adopt or maintain effective business practices;
- changes in the nature or operations of our customers;
- government regulations; and
- increased competition or other changes in the benefits marketplace.

If the number of individuals covered by our customers or the number of products or services subscribed to by our customers decreases for any reason, our revenue will likely decrease.

Failure to manage our continued growth effectively could increase our expenses, decrease our revenue, and prevent us from implementing our business strategy.

We have been experiencing continued growth, which could put a strain on our business. To manage this and our anticipated future growth effectively, we must continue to maintain and enhance our IT infrastructure, financial and accounting systems, and controls. We also must attract, train, and retain a significant number of qualified sales and marketing personnel, customer support personnel, professional services personnel, software engineers, technical personnel, and management personnel. Failure to effectively manage our growth could lead us to over-invest or under-invest in development and operations, result in weaknesses in our infrastructure, systems, or controls, give rise to operational mistakes, losses, loss of productivity or business opportunities, and result in loss of employees and reduced productivity of remaining employees. Our growth could require significant capital expenditures and might divert financial resources from other projects such as the development of new products and services. If our management is unable to effectively manage our growth, our expenses might increase more than expected, our revenue could decline or might grow more slowly than expected, and we might be unable to implement our business strategy. The quality of our products and services might suffer, which could negatively affect our reputation and harm our ability to retain and attract customers.

Economic uncertainties or downturns in the general economy or the industries in which our customers operate could disproportionately affect the demand for our solutions and negatively impact our results of operations.

General worldwide economic conditions have experienced significant downturns in the past, and market volatility and uncertainty remain widespread, including as a result statements and actions of the current U.S. presidential administration. All of this makes it extremely difficult for our customers and us to accurately forecast and plan future business activities. In addition, these conditions could cause our customers or prospective customers to decrease headcount, benefits, or HR budgets, which could decrease corporate spending on our products and services, resulting in delayed and lengthened sales cycles, a decrease in new customer acquisition, and/or loss of customers. Furthermore, during challenging economic times, our customers may have difficulty gaining timely access to sufficient credit or obtaining credit on reasonable terms, which could impair their ability to make timely payments to us and adversely affect our revenue. If that were to occur, our financial results could be harmed. Further, challenging economic conditions might impair the ability of our customers to pay for the products and services they already have purchased from us and, as a result, our write-offs of accounts receivable could increase. We cannot predict the timing, strength, or duration of any economic slowdown or recovery. If the condition of the general economy or markets in which we operate worsens, our business could be harmed.

If we fail to maintain awareness of our brand cost-effectively, our business might suffer.

We believe that maintaining awareness of our brand in a cost-effective manner is critical to continuing the widespread acceptance of our existing solutions and is an important element in attracting new customers. Furthermore, we believe that the importance of brand recognition will increase as competition in our market increases. Successful promotion of our brand will depend largely on the effectiveness of our marketing efforts and on our ability to provide reliable and useful services at competitive prices. Our efforts to build, maintain and market changes to our brand nationally have involved significant expenses. Brand promotion activities may not yield increased revenue, and even if they do, any increased revenue may not offset the expenses we incur in maintaining our brand. If we fail to successfully maintain our brand, or incur substantial expenses in an unsuccessful attempt to maintain our brand, we may fail to attract enough new customers or retain our existing customers to the extent necessary to realize a sufficient return on our brand-building efforts, and our business could suffer.

We might not be able to utilize a significant portion of our net operating loss or other tax credit carryforwards, which could adversely affect our profitability.

As of December 31, 2017, we had federal and state net operating loss carryforwards due to prior period losses, which if not utilized will begin to expire in 2022 for federal and state purposes. We also have South Carolina jobs tax credit and headquarters tax credit carryforwards, which if not utilized will begin to expire in 2020. These tax credit carryforwards could expire unused and be unavailable to offset future income tax liabilities, which could adversely affect our profitability.

In addition, under Section 382 of the Internal Revenue Code of 1986, as amended, or the Code, our ability to utilize net operating loss carryforwards or other tax attributes in any taxable year may be limited if we experience an “ownership change”. A Section 382 “ownership change” generally occurs if one or more stockholders or groups of stockholders who own at least 5% of our stock increase their ownership by more than 50 percentage points over their lowest ownership percentage within a rolling three-year period. Similar rules might apply under state tax laws. Future issuances of our stock could cause an “ownership change”. It is possible that an ownership change, or any future ownership change, could have a material effect on the use of our net operating loss carryforwards or other tax attributes, which could adversely affect our profitability.

We might be unable to adequately protect, and we might incur significant costs in enforcing, our intellectual property and other proprietary rights.

Our success depends in part on our ability to enforce our intellectual property and other proprietary rights. We rely on a combination of trademark, trade secret, copyright, patent, and unfair competition laws, as well as license and access agreements and other contractual provisions, to protect our intellectual property and other proprietary rights. In addition, we attempt to protect our intellectual property and proprietary information by requiring employees and consultants to enter into confidentiality, noncompetition, and assignment of inventions agreements. Our attempts to protect our intellectual property might be challenged by others or invalidated through administrative process or litigation. While we have eight U.S., three Chinese, two Japanese, Australian, Taiwanese, Hong Kong, and one Canadian patents granted and a number of applications pending, we might not be able to obtain meaningful patent protection for our software. In addition, if any patents are issued in the future, they might not provide us with any competitive advantages, or might be successfully challenged by third parties. Agreement terms that address non-competition are difficult to enforce in many jurisdictions and might not be enforceable in certain cases. To the extent that our intellectual property and other proprietary rights are not adequately protected, third parties might gain access to our proprietary information, develop and market products or services similar to ours, or use trademarks similar to ours, each of which could materially harm our business. Existing U.S. federal and state intellectual property laws offer only limited protection. Moreover, the laws of other countries in which we might in the future conduct operations or contract for services might afford little or no effective protection of our intellectual property. The failure to adequately protect our intellectual property and other proprietary rights could materially harm our business.

In addition, if we resort to legal proceedings to enforce our intellectual property rights or to determine the validity and scope of the intellectual property or other proprietary rights of others, the proceedings could be burdensome and expensive, even if we were to prevail. Any litigation that is necessary in the future could result in substantial costs and diversion of resources and could have a material adverse effect on our business, operating results or financial condition.

We might be sued by third parties for alleged infringement of their proprietary rights.

The software and Internet industries are characterized by the existence of a large number of patents, trademarks, and copyrights and by frequent litigation based on allegations of infringement or other violations of intellectual property rights. We have received in the past, and might receive in the future, communications from third parties claiming that we have infringed the intellectual property rights of others. Our technologies might not be able to withstand any third-party claims or rights against their use. Any intellectual property claims, with or without merit, could be time-consuming and expensive to resolve, divert management attention from executing our business plan, and require us to pay monetary damages or enter into royalty or licensing agreements. In addition, many of our contracts contain warranties with respect to intellectual property rights, and most require us to indemnify our clients for third-party intellectual property infringement claims, which would increase the cost to us of an adverse ruling on such a claim.

Moreover, any settlement or adverse judgment resulting from such a claim could require us to pay substantial amounts of money or obtain a license to continue to use the software or information that is the subject of the claim, or otherwise restrict or prohibit our use of it. We might not be able to obtain a license on commercially reasonable terms, if at all, from third parties asserting an infringement claim; we might not be able to develop alternative technology on a timely basis, if at all; and we might not be able to obtain a license to use a suitable alternative technology to permit us to continue offering, and our clients to continue using, our affected services. Accordingly, an adverse determination could prevent us from offering our services to others.

We might require additional capital to support business growth.

We intend to continue to make investments to support our business growth and might require additional funds to respond to business challenges or opportunities, including the need to develop new products and services or enhance our existing services, enhance our operating infrastructure, and acquire complementary businesses and technologies. Accordingly, we might need to engage in equity or debt financings to secure additional funds. If we raise additional funds through further issuances of equity or convertible debt securities, our existing stockholders could suffer significant dilution, and any new equity securities we issue could have rights, preferences and privileges superior to those of holders of our common stock. Any debt financing secured by us in the future could involve restrictive covenants relating to our capital-raising activities and other financial and operational matters, which might make it more difficult for us to obtain additional capital and to pursue business opportunities, including potential acquisitions. In addition, we might not be able to obtain additional financing on terms favorable to us, if at all. If we are unable to obtain adequate financing or financing on terms satisfactory to us when we require it, our ability to continue to support our business growth and to respond to business challenges could be significantly limited.

If we fail to meet our credit facility's financial covenants, our business and financial condition could be adversely affected.

Our credit facility contains financial covenants, including covenants related to financial liquidity and EBITDA. If at any point we fail to comply with the financial covenants, the lenders can demand immediate repayment of our outstanding balance and deny future borrowings under the credit facility. This could have a negative impact on our liquidity, thereby reducing the availability of cash flow for other purposes and adversely affecting our business.

Any future litigation against us could be costly and time-consuming to defend.

We may become subject, from time to time, to legal proceedings and claims that arise in the ordinary course of business such as claims brought by our clients in connection with commercial disputes, employment claims made by our current or former associates, or purported securities class actions. Litigation might result in substantial costs and may divert management's attention and resources, which might seriously harm our business, overall financial condition, and operating results. Insurance might not cover such claims, might not provide sufficient payments to cover all the costs to resolve one or more such claims, and might not continue to be available on terms acceptable to us. A claim brought against us that is uninsured or underinsured could result in unanticipated costs, thereby reducing our operating results and leading analysts or potential investors to reduce their expectations of our performance, which could reduce the trading price of our stock.

If we acquire companies or technologies in the future, they could prove difficult to integrate, disrupt our business, dilute stockholder value, and adversely affect our operating results and the value of our common stock.

As part of our business strategy, we might acquire, enter into joint ventures with, or make investments in complementary companies, services, and technologies in the future. For example, in 2010, we acquired the intellectual property assets of BeliefNetworks, Inc. We spent considerable time, effort, and money pursuing this company and successfully integrating it into our business. Acquisitions and investments involve numerous risks, including:

- difficulties in identifying and acquiring products, technologies or businesses that will help our business;
- difficulties in integrating operations, technologies, services and personnel;
- diversion of financial and managerial resources from existing operations;
- risk of entering new markets in which we have little to no experience; and
- delays in customer purchases due to uncertainty and the inability to maintain relationships with customers of the acquired businesses.

If we fail to properly evaluate acquisitions or investments, we might not achieve the anticipated benefits of any such acquisitions, we might incur costs in excess of what we anticipate, and management resources and attention might be diverted from other necessary or valuable activities.

Future sales to customers outside the United States or with international operations might expose us to risks inherent in international sales which, if realized, could adversely affect our business.

An element of our growth strategy is to expand internationally. Operating in international markets requires significant resources and management attention and will subject us to regulatory, economic, and political risks that are different from those in the United States. Because of our limited experience with international operations, our international expansion efforts might not be successful in creating demand for our products and services outside of the United States or in effectively selling our solutions in the international markets we enter. In addition, we will face risks in doing business internationally that could adversely affect our business, including:

-

unstable regional political and economic conditions, such as those caused by statements and actions by the current U.S. presidential administration and the U.K. exit from the European Union;

- the need to localize and adapt our solutions for specific countries, including translation into foreign languages and associated expenses;
- data privacy laws which require that customer data be stored and processed in a designated territory;
- difficulties in staffing and managing foreign operations;
- different pricing environments, longer sales cycles and longer accounts receivable payment cycles and collections issues;
- new and different sources of competition;
- weaker protection for intellectual property and other legal rights than in the United States and practical difficulties in enforcing intellectual property and other rights outside of the United States;
- laws and business practices favoring local competitors;
- compliance challenges related to the complexity of multiple, conflicting and changing governmental laws and regulations, including employment, tax, privacy, and data protection laws and regulations;
- increased financial accounting and reporting burdens and complexities;

restrictions on the transfer of funds; and
adverse tax consequences.

If we denominate our international contracts in local currencies, fluctuations in the value of the U.S. dollar and foreign currencies might impact our operating results when translated into U.S. dollars.

If we are required to collect sales and use taxes in additional jurisdictions, we might be subject to liability for past sales and our future sales may decrease.

We might lose sales or incur significant expenses if states successfully impose broader guidelines on state sales and use taxes. A successful assertion by one or more states requiring us to collect sales or other taxes on the licensing of our software or sale of our services could result in substantial tax liabilities for past transactions and otherwise harm our business. In addition, each state has different rules and regulations governing sales and use taxes, and these rules and regulations are subject to varying interpretations that change over time. We review these rules and regulations periodically and, when we believe we are subject to sales and use taxes in a particular state, voluntarily engage state tax authorities in order to determine how to comply with their rules and regulations. We cannot assure you that we will not be subject to sales and use taxes or related penalties for past sales in states where we currently believe no such taxes are required.

Vendors of services, like us, are typically held responsible by taxing authorities for the collection and payment of any applicable sales and similar taxes. If one or more taxing authorities determines that taxes should have, but have not, been paid with respect to our services, we might be liable for past taxes in addition to taxes going forward. Liability for past taxes might also include substantial interest and penalty charges. Our customer contracts typically provide that our customers must pay all applicable sales and similar taxes. Nevertheless, our customers might be reluctant to pay back taxes and might refuse responsibility for interest or penalties associated with those taxes. If we are required to collect and pay back taxes and the associated interest and penalties, and if our clients fail or refuse to reimburse us for all or a portion of these amounts, we will incur unplanned expenses that may be substantial. Moreover, imposition of such taxes on us going forward will effectively increase the cost of our software and services to our customers and might adversely affect our ability to retain existing customers or to gain new customers in the areas in which such taxes are imposed.

Risks Related to Our Products and Services Offerings

If our security measures are breached or fail, and unauthorized persons gain access to customers' and consumers' data, our products and services might be perceived as not being secure, customers and consumers might curtail or stop using our products and services, and we might incur significant liabilities.

Our products and services involve the storage and transmission of customers' and consumers' confidential information, which may include sensitive individually identifiable information that is subject to stringent legal and regulatory obligations. Because of the sensitivity of this information, security features of our software are very important. If our security measures are breached or fail and/or are bypassed as a result of third-party action, inadvertent disclosures through technological or human error (including employee error), malfeasance, hacking, ransomware, social engineering (including phishing schemes), computer viruses, malware, or otherwise, someone might be able to acquire or obtain unauthorized access to our customers' confidential information and/or patient data or other personal information. As a result, our reputation could be damaged, our business might suffer, information might be lost, and we could face damages for contract breach, penalties for violation of applicable laws or regulations, costly litigation or government investigations, and significant costs for remediation and remediation efforts to prevent future occurrences.

In addition, we rely on various third parties, including employers' HR departments, carriers, and other third-party service providers and consumers themselves, as users of our system for key activities to protect and promote the security of our systems and the data and information accessible within them, such as administration of enrollment, consumer status changes, claims, and billing. Our customers might authorize or enable third parties to access their information and data that is stored on our systems. Because we do not control such access, we cannot ensure the complete integrity or security of such data in our systems. On occasion, people have failed to adhere to appropriate data security practices. For example, employers sometimes have failed to terminate the login/password of former employees, or permitted current employees to share login/passwords. When we become aware of such security incidents, we work with employers to terminate inappropriate access and provide additional instruction in order to avoid the reoccurrence of such problems. Although to date these security incidents have not resulted in claims against us or in material harm to our business, failures to perform these activities might result in claims against us, which could expose us to significant expense, legal liability, and harm to our reputation, which might result in loss of business.

Because techniques used to obtain unauthorized access or to sabotage systems change frequently and often are not recognized until launched against a target, we might not be able to anticipate these techniques or to implement adequate preventive measures. If an actual or perceived breach of our security, or the security of third parties that we rely on, occurs, the market perception of the effectiveness of our security measures could be harmed and we could lose sales and customers. Any significant violations of data privacy or security laws could result in the loss of business, litigation and regulatory investigations and penalties or settlements that could damage our reputation and adversely impact our results of operations and financial condition. In addition, our customers might authorize or enable third parties to access their information and data that is stored on our systems. Because we do not control such access, we cannot ensure the complete integrity or security of such data in our systems.

Failure by our customers to obtain proper permissions and waivers might result in claims against us or may limit or prevent our use of data, which could harm our business.

We require our customers to provide necessary notices and to obtain necessary permissions and waivers for use and disclosure of information on the Benefitfocus Platform, and we require contractual assurances from them that they have done so and will do so. If, however, despite these requirements and contractual obligations, our customers do not obtain necessary permissions and waivers, then our use and disclosure of information that we receive from them or on their behalf might be limited or prohibited by state or federal privacy laws or other laws. This could impair our functions, processes and databases that reflect, contain, or are based upon such data and might prevent use of such data. In addition, this could interfere with, or prevent creation or use of, rules, analyses, or other data-driven activities that benefit us and our business. Moreover, we might be subject to claims or liability for use or disclosure of information by reason of lack of valid notices, agreements, permissions or waivers. These claims or liabilities could subject us to unexpected costs and adversely affect our operating results.

Our proprietary software might not operate properly, which could damage our reputation, give rise to claims against us, or divert application of our resources from other purposes, any of which could harm our business and operating results.

Proprietary software development is time-consuming, expensive, and complex. Unforeseen difficulties can arise. We might encounter technical obstacles, and it is possible that we discover problems that prevent our proprietary applications from operating properly. If they do not function reliably or fail to achieve customer expectations in terms of performance, customers could assert liability claims against us and/or attempt to cancel their contracts with us. This could damage our reputation and impair our ability to attract or maintain customers.

Moreover, benefits management software as complex as ours has in the past contained, and may in the future contain, or develop, undetected defects or errors. Material performance problems or defects in our products and services might arise in the future. Errors might result from the interface of our services with legacy systems and data, which we did not develop and the function of which is outside of our control. Defects or errors might arise in our existing or new software or service processes. Because changes in employer, carrier, and legal requirements and practices relating to benefits are frequent, we are continuously discovering defects and errors in our software and service processes compared against these requirements and practices. Undiscovered vulnerabilities could expose our software to unscrupulous third parties who develop and deploy software programs that could attack our software or result in unauthorized access to customer data. Defects and errors and any failure by us to identify and address them could result in loss of revenue or market share, liability to customers or others, failure to achieve market acceptance or expansion, diversion of development and other resources, injury to our reputation, and increased service and maintenance costs. Defects or errors in our product or service processes might discourage existing or potential customers from purchasing services from us. Correction of defects or errors could prove to be impossible or impracticable. The costs incurred in correcting any defects or errors or in responding to resulting claims or liability might be substantial and could adversely affect our operating results.

In addition, customers that rely on our products and services to collect, manage, and report benefits data might have a greater sensitivity to service errors and security vulnerabilities than customers of software products in general. We market and sell services that, among other things, provide information to assist care providers in tracking and treating ill patients. Any operational delay in or failure of our software service processes might result in the disruption of patient care and could cause harm to our business and operating results.

Our customers might assert claims against us in the future alleging that they suffered damages due to a defect, error, or other failure of our product or service processes. A product liability claim or errors or omissions claim could subject us to significant legal defense costs and adverse publicity regardless of the merits or eventual outcome of such a claim.

Various events could interrupt customers' access to the Benefitfocus Platform, exposing us to significant costs.

The ability to access the Benefitfocus Platform is critical to our customers. Our operations and facilities are vulnerable to interruption and/or damage from a number of sources, many of which are beyond our control, including, without limitation: (i) power loss and telecommunications failures, (ii) fire, flood, hurricane, and other natural disasters, (iii) software and hardware errors, failures or crashes in our own systems or in other systems, (iv) computer viruses, denial-of-service attacks, hacking and similar disruptive problems in our own systems and in other systems, and (v) civil unrest, war, and/or terrorism. We have implemented various measures to protect against interruptions of customers' access to our platform. If customers' access is interrupted because of problems in the operation of our facilities, we could be exposed to significant claims by customers, particularly if the access interruption is associated with problems in the timely delivery of funds due to customers or medical information relevant to patient care. Our plans for disaster recovery and business continuity rely on third-party providers of related services. If those vendors fail us at a time when our systems

are not operating correctly, we could incur a loss of revenue and liability for failure to fulfill our obligations. Any significant instances of system downtime could negatively affect our reputation and ability to retain customers and sell our services, which would adversely impact our revenue.

In addition, retention and availability of patient care and physician reimbursement data are subject to federal and state laws governing record retention, accuracy, and access. Some laws impose obligations on our customers and on us to produce information for third parties and to amend or expunge data at their direction. Our failure to meet these obligations might result in liability, which could increase our costs and reduce our operating results.

We rely on data center providers, Internet infrastructure, bandwidth providers, third-party computer hardware and software, other third parties, and our own systems for providing services to our customers, and any failure or interruption in the services provided by these third parties or our own systems could expose us to litigation and negatively impact our relationships with customers, adversely affecting our brand and our business.

We serve all our customers from two data centers, one located in Raleigh, North Carolina and the other located in Charlotte, North Carolina. While we control and have access to our servers, we do not control the operation of these facilities. The owners of our data center facilities have no obligation to renew their agreements with us on commercially reasonable terms, or at all. If we are unable to renew these agreements on commercially reasonable terms, or if one of our data center operators is acquired, we may be required to transfer our servers and other infrastructure to new data center facilities, and we may incur significant costs and possible service interruption in connection with doing so. Problems faced by our third-party data center locations, with the telecommunications network providers with whom we or they contract, or with the systems by which our telecommunications providers allocate capacity among their customers, including us, could adversely affect the experience of our customers. Our third-party data centers operators could decide to close their facilities without adequate notice. In addition, any financial difficulties, such as bankruptcy faced by our third-party data centers operators or any of the service providers with whom we or they contract may have negative effects on our business, the nature and extent of which are difficult to predict.

In addition, our ability to deliver our web-based services depends on the development and maintenance of the infrastructure of the Internet by third parties. This includes maintenance of a reliable network backbone with the necessary speed, data capacity, bandwidth capacity, and security. Our services are designed to operate without interruption in accordance with our service level commitments. However, we have experienced and expect that we will experience future interruptions and delays in services and availability from time to time. In the event of a catastrophic event with respect to one or more of our systems, we may experience an extended period of system unavailability, which could negatively impact our relationship with customers. To operate without interruption, both we and our service providers must guard against:

- damage from fire, power loss, natural disasters and other force majeure events outside our control;
- communications failures;
- software and hardware errors, failures, and crashes;
- security breaches, computer viruses, hacking, denial-of-service attacks, and similar disruptive problems; and
- other potential interruptions.

We also rely on computer hardware purchased or leased and software licensed from third parties in order to offer our services, including software from Oracle Corporation and Microsoft Corporation, and routers and network equipment from Cisco, Dell and Hewlett-Packard Company. This hardware and software is generally commercially available on varying terms. However, it is possible that this hardware and software might not continue to be available on commercially reasonable terms, or at all. Any loss of the right to use any of this hardware or software could result in delays in the provisioning of our services until equivalent technology is either developed by us, or, if available, is identified, obtained and integrated.

We exercise limited control over third-party vendors, which increases our vulnerability to problems with technology and information services they provide. Interruptions in our network access and services might in connection with third-party technology and information services reduce our revenue, cause us to issue refunds to customers for prepaid and unused subscription services, subject us to potential liability, or adversely affect our renewal rates. Although we maintain insurance for our business, the coverage under our policies might not be adequate to compensate us for all losses that may occur. In addition, we might not be able to continue to obtain adequate insurance coverage at an acceptable cost, if at all.

The use of open source software in our products and solutions may expose us to additional risks and harm our intellectual property rights.

Some of our products and solutions use or incorporate software that is subject to one or more open source licenses. Open source software is typically freely accessible, usable, and modifiable. Certain open source software licenses require a user who intends to distribute the open source software as a component of the user's software to disclose publicly part or all of the source code to the user's software. In addition, certain open source software licenses require the user of such software to make any derivative works of the open source code available to others on potentially unfavorable terms or at no cost.

The terms of many open source licenses to which we are subject have not been interpreted by U.S. or foreign courts. Accordingly, there is a risk that those licenses could be construed in a manner that imposes unanticipated conditions or restrictions on our ability to commercialize our solutions. In that event, we could be required to seek licenses from third parties in order to continue offering our products or solutions, to re-develop our products or solutions, to discontinue sales of our products or solutions, or to release our proprietary software code under the terms of an open source license, any of which could harm our business. Further, given the nature of open source software, it may be more likely that third parties might assert copyright and other intellectual property infringement claims against us based on our use of these open source software programs.

While we monitor the use of all open source software in our products, solutions, processes, and technology and try to ensure that no open source software is used in such a way as to require us to disclose the source code to the related product or solution when we do not wish to do so, it is possible that such use may have inadvertently occurred in deploying our proprietary solutions. In addition, if a third-party software provider has incorporated certain types of open source software into software we license from such third party for our products and solutions without our knowledge, we could, under certain circumstances, be required to disclose the source code to our products and solutions. This could harm our intellectual property position and our business, results of operations, and financial condition.

Risks Related to Regulation

Government regulation of the areas in which we operate creates risks and challenges with respect to our compliance efforts and our business strategies.

The employee benefits industry is highly regulated and is subject to changing political, legislative, regulatory, and other influences. Deregulatory efforts following the U.S. presidential and other elections in 2016 are ongoing, and the outcome of the 2018 elections could further impact the regulatory environment in our industry. Existing and new laws and regulations affecting the employee benefits industry could create unexpected liabilities for us, cause us to incur additional costs and restrict our operations. These laws and regulations are complex and their application to specific services and relationships are not clear. In particular, many existing laws and regulations affecting employee benefits, when enacted, did not anticipate the services that we provide, and these laws and regulations might be applied to our services in ways that we do not anticipate. Our failure to accurately anticipate the application of these laws and regulations, or our failure to comply, could create liability for us, result in adverse publicity, and negatively affect our business. Some of the risks we face from the regulation of employee benefits are as follows:

• **PPACA.** Health benefits are obtained, delivered, accessed, and maintained under an increasingly intricate and uncertain statutory and regulatory framework. In particular, ongoing efforts to repeal part or all of the Patient Protection and Affordable Care Act (“PPACA”) have created uncertainty in the healthcare industry broadly. Although many of the provisions of PPACA do not directly apply to us, PPACA and continued efforts to repeal or modify the law may affect the business of many of our customers. For instance, carriers and large employers might experience changes in the numbers of individuals they insure as a result of the elimination of the penalty associated with PPACA’s individual mandate, possible repeal of guaranteed issue, and flux in the state and national exchanges under PPACA. In addition, the number of states that have chosen to expand Medicaid and to adopt state-specific exchanges remains in flux. Although we are unable to predict with any reasonable certainty or otherwise quantify the likely impact of PPACA and related repeal efforts and deregulatory initiatives on our business model, financial condition, or results of operations, changes in the business of our customers and the number of individuals they insure may negatively impact our business.

• **False or Fraudulent Claim Laws.** There are numerous federal and state laws that forbid submission of false information or the failure to disclose certain information in connection with submission and payment of claims for reimbursement from the government. In some cases, these laws also forbid abuse of existing systems for such

submission and payment. In addition, federal and state laws prohibit kickbacks in association with the provision of healthcare services. Many of these state laws pertain to all payors, not just items or services paid for by the federal government. Although our business operations are generally not subject to these laws and regulations, any contract we have with a government entity requires us to comply with these laws and regulations. Any failure of our services to comply with these laws and regulations could result in substantial liability, including but not limited to criminal liability, could adversely affect demand for our services, and could force us to expend significant capital, research and development, and other resources to address the failure. Any determination by a court or regulatory agency that our services with government clients violate these laws and regulations could subject us to civil or criminal penalties, invalidate all or portions of some of our government client contracts, require us to change or terminate some portions of our business, require us to refund portions of our services fees, cause us to be disqualified from serving not only government clients but also all clients doing business with government payers, and have an adverse effect on our business.

HIPAA and Other Privacy and Security Requirements. There are numerous U.S. federal and state laws and regulations related to the privacy and security of personal health information. In particular, regulations promulgated pursuant to the Health Insurance Portability and Accountability Act of 1996, or HIPAA, established privacy and security standards that limit the use and disclosure of protected health information, and require the implementation of administrative, physical, and technological safeguards to ensure the confidentiality, integrity, availability, and privacy of protected health information. Health plans, healthcare clearinghouses, and most providers are “Covered Entities” subject to HIPAA. With respect to our operations as a healthcare clearinghouse, we are directly subject to the privacy regulations established under HIPAA, or the Privacy Rule, and the security regulations established under HIPAA, or the Security Rule. In addition, our carrier

customers, or payors, are considered to be Covered Entities and are required to enter into written agreements with us, known as Business Associate Agreements, under which we are considered to be a “Business Associate” and that require us to safeguard protected health information and restrict how we may use and disclose such information. Both Covered Entities and Business Associates are subject to direct oversight and audit by the Department of Health and Human Services.

Violations of HIPAA might result in civil fines of up to \$55,910 per violation and a maximum civil penalty of \$1,677,299 in a calendar year for violations of the same requirement, as well as criminal penalties. State attorneys general may bring civil actions seeking either injunctions or damages in response to violations of HIPAA that threaten the privacy of state residents. Moreover, the U.S. Department of Health and Human Services’ Office for Civil Rights (“OCR”) operates a formal HIPAA audit program. The audits are intended to assess compliance with HIPAA by both Covered Entities and Business Associates and are conducted by OCR with assistance from third-party vendors. Issues identified during the audits may result in agency-imposed corrective action plans or civil monetary penalties.

We might not be able to adequately address the business risks created by HIPAA implementation and enforcement. Furthermore, we are unable to predict what changes to HIPAA or other laws or regulations might be made in the future or how those changes could affect our business or the costs of compliance. Noncompliance may result in litigation and high-dollar fines or settlements.

Some payors and clearinghouses interpret HIPAA transaction requirements differently than we do. Where payors or clearinghouses require conformity with their interpretations as a condition of a successful transaction, we seek to comply with their interpretations.

In addition to the Privacy Rule and Security Rule, most states have enacted patient confidentiality laws that protect against the disclosure of confidential medical and/or health information, and many states have adopted or are considering further legislation in this area, including privacy safeguards, security standards, and data security breach notification requirements. Such state laws, if more stringent than HIPAA requirements, are not preempted by the federal requirements, and we are required to comply with them. Failure by us to comply with any state standards regarding patient privacy may subject us to penalties, including civil monetary penalties and, in some circumstances, criminal penalties. Such failure may injure our reputation and adversely affect our ability to retain customers and attract new customers.

Personal Privacy and Consumer Protection. There are numerous U.S. federal and state laws and regulations that have been adopted or are being considered regarding the collection, retention, use, and disclosure of personal information. In addition to HIPAA, we might be subject to various laws, rules and regulations related to privacy and information security such as those promulgated under the Gramm-Leach-Bliley Act and various state laws regulating the use and security of personal information. Those laws, rules, and regulations include requirements such as reasonable and appropriate safeguards to protect personal information, or providing appropriate notice to consumers about how their personal information will be used or disclosed. In addition, U.S. state legislatures have been actively enacting new laws addressing data security, security breach notification, and privacy, including the California Consumer Privacy Act of 2018. These areas may present implementation challenges and could be an enforcement priority for the state regulators generating increased lawsuits by consumers and other individuals. Our management believes that we are currently operating in compliance with these regulations. However, continued compliance with these evolving laws, rules and regulations regarding the privacy, security and protection of our customers’ data, or the implementation of any additional privacy rules and regulations, could result in higher compliance and technology costs for us.

Medicare and Medicaid Regulatory Requirements. We have contracts with insurance carriers who offer Medicare Managed Care (also known as Medicare Advantage or Medicare Part C) and Medicaid Managed Care benefits plans. We also have contracts with insurance carriers who offer Medicare prescription drug benefits (also known as Medicare Part D) plans. The activities of the Medicare plans are regulated by the Centers for Medicare & Medicaid Services, or CMS, the federal agency that provides oversight of the Medicare and Medicaid programs. The Medicaid

Managed Care plans are regulated by both CMS and the individual states where the plans are offered. Some of the activities that we might perform, such as the enrollment of beneficiaries, may be subject to CMS and/or state regulation, and such regulations may force us to change the way we do business or otherwise restrict our ability to provide services to such plans. Moreover, the regulatory environment with respect to these programs has become, and will likely continue to become, increasingly complex.

Financial Services-Related Laws and Rules. Financial services and electronic payment processing services are subject to numerous laws, regulations and industry standards, some of which might impact our operations and subject us, our vendors, and our customers to liability as a result of the payment distribution and processing solutions we offer. Although we do not act as a bank, we offer solutions that involve banks, or vendors who contract with banks and other regulated providers of financial services. As a result, we might be impacted by banking and financial services industry laws, regulations, and industry standards, such as licensing requirements, solvency standards, requirements to maintain the privacy and security of nonpublic personal financial information, and Federal Deposit Insurance Corporation deposit insurance limits. In addition, our patient billing and payment distribution and processing solutions might be impacted by payment card association operating rules, certification requirements, and rules governing electronic funds transfers. If we fail to comply with applicable payment processing rules or requirements, we might be subject to fines and changes in transaction fees and may lose our ability to process credit and debit card transactions or facilitate other types of billing and payment solutions. Moreover, payment transactions processed using the Automated Clearing House are subject to network operating rules promulgated by the National Automated Clearing House Association and to various federal laws regarding

such operations, including laws pertaining to electronic funds transfers, and these rules and laws might impact our billing and payment solutions. Further, our solutions might impact the ability of our payor customers to comply with state prompt payment laws. These laws require payors to pay healthcare claims meeting the statutory or regulatory definition of a “clean claim” within a specified time frame.

Insurance Broker Laws. Insurance laws in the United States are often complex, and states have broad authority to adopt regulations regarding brokerage activities. Our business's regulatory oversight generally also includes activity governing the selection and payment of insurance products and the licensing of insurance brokers and our wholly owned subsidiary, BenefitStore, Inc., is an insurance agency. Our continuing ability to provide insurance brokerage related services in the jurisdictions in which we operate depends on our compliance with the rules and regulations promulgated from time to time by the regulatory authorities in each of these jurisdictions.

ERISA. The Employee Retirement Income Security Act of 1974, as amended, or ERISA, regulates how employee benefits are provided to or through certain types of employer-sponsored health benefits plans. ERISA is a set of laws and regulations that is subject to periodic interpretation by the U.S. Department of Labor as well as the federal courts. In some circumstances, and under certain customer contracts, we might be deemed to have assumed duties that make us an ERISA fiduciary, and thus be required to carry out our operations in a manner that complies with ERISA in all material respects. We believe that our current operations do not render us subject to ERISA fiduciary obligations, and therefore that we are in material compliance with ERISA and that any such compliance does not currently have a material adverse effect on our operations. However, there can be no assurance that continuing ERISA compliance efforts or any future changes to ERISA will not have a material adverse effect on us.

Third-Party Administrator Laws. Numerous states in which we do business have adopted regulations governing entities engaged in third-party administrator, or TPA, activities. TPA regulations typically impose requirements regarding enrollment into benefits plans, claims processing and payments, and the handling of customer funds. Although we do not believe we are currently acting as a TPA, changes in state regulations could result in us being obligated to comply with such regulations, which might require us to obtain licenses to provide TPA services in such states.

We are subject to banking regulations that may limit our business activities.

The Goldman Sachs Group, affiliates of which owned approximately 11.7% of the voting and economic interest in our business at September 30, 2018, is regulated as a bank holding company and a financial holding company under the Bank Holding Company Act of 1956, as amended, or BHC Act. The BHC Act imposes regulations and requirements on The Goldman Sachs Group and on any company that is deemed to be controlled by The Goldman Sachs Group under the BHC Act and the regulations of the Board of Governors of the Federal Reserve System, or the Federal Reserve. Due to the size of its voting and economic interest, we might still be deemed to be controlled by The Goldman Sachs Group and are therefore considered to be a non-bank “subsidiary” of The Goldman Sachs Group under the BHC Act. We will remain subject to this regulatory regime until The Goldman Sachs Group is no longer deemed to control us for purposes of the BHC Act, which we do not generally have the ability to control and which will not occur until The Goldman Sachs Group has significantly reduced its voting and economic interest in us.

As a controlled non-bank subsidiary of The Goldman Sachs Group, we are restricted from engaging in activities that are not permissible under the BHC Act, or the rules and regulations promulgated thereunder. Permitted activities for a bank holding company or any controlled non-bank subsidiary generally include activities that the Federal Reserve has previously determined to be closely related to banking, financial in nature or incidental or complementary to financial activities, including data processing services such as those that we provide with our software solutions. Restrictions placed on The Goldman Sachs Group as a result of supervisory or enforcement actions under the BHC Act or otherwise may restrict us or our activities in certain circumstances, even if these actions are unrelated to our conduct or business. Further, as a result of being subject to regulation and supervision by the Federal Reserve, we may be required to obtain the prior approval of the Federal Reserve before engaging in certain new activities or businesses, whether organically or by acquisition. The Federal Reserve could exercise its power to restrict us from engaging in any activity that, in the Federal Reserve’s opinion, is unauthorized or constitutes an unsafe or unsound business

practice. To the extent that these regulations impose limitations on our business, we could be at a competitive disadvantage because some of our competitors are not subject to these limitations.

Additionally, any failure of The Goldman Sachs Group to maintain its status as a financial holding company could result in further limitations on our activities and our growth. In particular, our permissible activities could be restricted to only those that constitute banking or activities closely related to banking. The Goldman Sachs Group's loss of its financial holding company status could be caused by several factors, including any failure by The Goldman Sachs Group's bank subsidiaries to remain sufficiently capitalized, by any examination downgrade of one of The Goldman Sachs Group's bank subsidiaries, or by any failure of one of The Goldman Sachs Group's bank subsidiaries to maintain a satisfactory rating under the Community Reinvestment Act. In addition, The Goldman Sachs Group is required to remain "well capitalized" and "well managed" in order to maintain its status as a financial holding company. We have no ability to prevent such occurrences from happening.

As a non-bank subsidiary of a bank holding company, we are subject to examination by the Federal Reserve and required to provide information and reports for use by the Federal Reserve under the BHC Act. In addition, we may be subject to regulatory oversight and examination because we are a technology service provider to regulated financial institutions. The Federal Reserve may also impose substantial fines and other penalties for violations of applicable banking laws, regulations and orders. Further, the Dodd-

Frank Act, including Title VI thereunder known as the “Volcker Rule”, and related financial regulatory reform has resulted in the issuance of numerous regulations designed to increase and strengthen the regulation of bank holding companies, including The Goldman Sachs Group and its affiliates. The Volcker Rule, in relevant part, restricts banking entities from proprietary trading (subject to certain exemptions) and from acquiring or retaining any equity, partnership or other interests in, or sponsoring, a private equity fund, subject to satisfying certain conditions, and from engaging in certain transactions with funds.

We have agreed to certain covenants that are intended to facilitate The Goldman Sachs Group’s compliance with the BHC Act, but that may impose certain obligations on our company. In particular, The Goldman Sachs Group has rights to conduct audits on, and access certain information of, our company and certain rights to review the policies and procedures that we implement to comply with the laws and regulations that relate to our activities. In addition, we are obligated to provide The Goldman Sachs Group with notice of certain events and business activities and cooperate with The Goldman Sachs Group to mitigate potential adverse consequences resulting therefrom.

Potential regulatory requirements placed on our software, services, and content could impose increased costs on us, delay or prevent our introduction of new service types, and impair the function or value of our existing service types.

Our products and services are and are likely to continue to be subject to increasing regulatory requirements in a number of ways. As these requirements proliferate, we must change or adapt our products and services to comply. Changing regulatory requirements might render our services obsolete or might block us from accomplishing our work or from developing new services. This might in turn impose additional costs upon us to comply or to further develop our products and services. It might also make introduction of new product or service types more costly or more time-consuming than we currently anticipate. It might even prevent introduction by us of new products or services or cause the continuation of our existing products or services to become unprofitable or impossible.

Potential government subsidy of services similar to ours, or creation of a single payor system, might reduce customer demand.

Recently, entities including brokers and U.S. federal and state governments have offered to subsidize adoption of online benefits platforms or clearinghouses. In addition, federal regulations have been changed to permit such subsidy from additional sources subject to certain limitations. To the extent that we do not qualify or participate in such subsidy programs, demand for our services might be reduced, which may decrease our revenue. In addition, prior proposals regarding healthcare reform have included the concept of creation of a single payor for healthcare insurance. This kind of consolidation of critical benefits activity could negatively impact the demand for our services.

Our services present the potential for embezzlement, identity theft, or other similar illegal behavior by our associates with respect to third parties.

Among other things, certain services offered by us involve collecting payment information from individuals, and this frequently includes check and credit card information. Even though we do not handle direct payments, our services also involve the use and disclosure of personal and business information that could be used to impersonate third parties, commit identity theft, or otherwise gain access to their data or funds. If any of our associates take, convert, or misuse such funds, documents, or data, we could be liable for damages, and our business reputation could be damaged or destroyed. Moreover, if we fail to adequately prevent third parties from accessing personal and/or business information and using that information to commit identity theft, we might face legal liabilities and other losses than can have a negative impact on our business.

Risks Related to Ownership of Our Common Stock

Our stock price may be volatile or may decline regardless of our operating performance, and you may not be able to resell your shares at or above the price at which you purchase it.

The stock market historically has experienced extreme price and volume fluctuations. As a result of this volatility, you might not be able to sell your common stock at or above the price at which you purchase it. The public market for our stock is new. From our IPO in September 2013 through September 30, 2018, the per share trading price of our common stock has been as high as \$77.00 and as low as \$19.58. It might continue to fluctuate significantly in response to various factors, some of which are beyond our control. These factors include:

- our operating performance and the operating performance of similar companies;
- the overall performance of the equity markets;
- changes in laws or regulations relating to the sale of health insurance;
- announcements by us or our competitors of acquisitions, business plans, or commercial relationships;
- any major change in our management;
- threatened or actual litigation;
- publication of research reports or news stories about us, our competitors, or our industry, or positive or negative recommendations or withdrawal of research coverage by securities analysts;

large volumes of sales of our shares of common stock by existing stockholders; and
general political and economic conditions.

In addition, the stock market in general, and the market for Internet-related companies in particular, has experienced extreme price and volume fluctuations that have often been unrelated or disproportionate to the operating performance of those companies. These fluctuations might be even more pronounced in the relatively new trading market for our stock. Additionally, securities class action litigation has often been instituted against companies following periods of volatility in the overall market and in the market price of a company's securities. This litigation, if instituted against us, could result in substantial costs, divert our management's attention and resources, and harm our business, operating results, and financial condition.

We do not currently intend to pay dividends on our common stock and, consequently, your ability to achieve a return on your investment will depend on appreciation in the price of our common stock.

We have never declared or paid any cash dividends on our common stock and do not currently intend to do so for the foreseeable future. We currently intend to invest our future earnings, if any, to fund our growth. Therefore, you are not likely to receive any dividends on your common stock for the foreseeable future, and the success of an investment in shares of our common stock will depend upon future appreciation in its value, if any. There is no guarantee that shares of our common stock will appreciate in value or even maintain the price at which our stockholders purchased their shares.

Our stock price could decline due to the large number of outstanding shares of our common stock eligible for future sale.

Sales of a substantial number of shares of our common stock in the public market or the market perception that the holder or holders of a large number of shares intend to sell shares, could reduce the market price of our common stock. These sales could make it more difficult for us to sell equity or equity related securities in the future at a time and price that we deem appropriate.

As of September 30, 2018, we had an aggregate of 31,899,960 shares of common stock outstanding. As of September 30, 2018, there also were outstanding options and restricted stock units to purchase 2,409,045 shares of our common stock that, if exercised or vested, as applicable, will result in these additional shares becoming available for sale subject in some cases to Rule 144. We have also registered an aggregate of 9,099,766 shares of our common stock that we may issue or sell under our stock plans. These shares can be freely sold in the public market upon issuance, unless they are held by "affiliates", as that term is defined in Rule 144 of the Securities Act. If a large number of these shares are sold in the public market, the sales could reduce the trading price of our common stock.

A limited number of stockholders will have the ability to influence the outcome of director elections and other matters requiring stockholder approval.

As of September 30, 2018, our directors, executive officers, and their affiliated entities beneficially owned approximately 21.2% of our outstanding common stock. In particular, GS Capital Partners VI Parallel, L.P., GS Capital Partners VI Offshore Fund, L.P., GS Capital Partners VI Fund, L.P., and GS Capital Partners VI GmbH & CO. KG, which are affiliates of Goldman, Sachs & Co. and which we refer to as the Goldman Funds, collectively beneficially owned approximately 11.7%. These stockholders, if they act together, could exert substantial influence over matters requiring approval by our stockholders, including the amendment of our certificate of incorporation and bylaws, and the approval of mergers or other business combination transactions.

Additionally, the Goldman Funds, Mason R. Holland, Jr., our Executive Chairman and a director, and Shawn A. Jenkins, our Senior Advisor for Innovation and a director until April 1, 2018, entered into a voting agreement for the

election of directors. As of June 30, 2018, these stockholders collectively beneficially owned approximately 28.7% of our common stock. Pursuant to the voting agreement, until September 2018 the parties are obligated to vote all of their shares to elect two directors nominated by the Goldman Funds and each of Messrs. Holland and Jenkins to our board of directors, if requested. As a result, these stockholders will have significant influence on the outcome of director elections. This concentration of ownership might discourage, delay, or prevent a change in control of our company, which could deprive our stockholders of an opportunity to receive a premium for their stock as part of a sale of our company and might reduce our stock price. These actions may be taken even if they are opposed by other stockholders.

Our business is subject to changing regulations regarding corporate governance, disclosure controls, internal control over financial reporting, and other compliance areas that will increase both our costs and the risk of noncompliance.

As a public company, we are subject to the reporting requirements of the Securities Exchange Act of 1934, or the Exchange Act, the Sarbanes-Oxley Act of 2002, or the Sarbanes-Oxley Act, the Dodd-Frank Act, and the rules and regulations of our stock exchange. The requirements of these rules and regulations increase our legal, accounting, and financial compliance costs, make some activities more difficult, time-consuming, and costly, and may also place undue strain on our personnel, systems, and resources.

The Sarbanes-Oxley Act requires, among other things, that we maintain effective disclosure controls and procedures and internal control over financial reporting. Commencing with our fiscal year ending December 31, 2014, we performed system and process evaluation and testing of our internal control over financial reporting to allow management to report on the effectiveness of our internal control over financial reporting, as required by Section 404 of the Sarbanes-Oxley Act. We also are required to disclose changes made

to our internal controls and procedures on a quarterly basis. Our ongoing compliance with Section 404 of the Sarbanes-Oxley Act will require that we incur substantial accounting expense and expend significant management efforts.

In addition, we anticipate we will no longer qualify as an “emerging growth company” as defined in the Jumpstart Our Business Startups Act of 2012, or the JOBS Act, as of December 31, 2018. Accordingly, our independent registered public accounting firm will be required to formally attest to the effectiveness of our internal control over financial reporting pursuant to Section 404 of the Sarbanes-Oxley Act in our Annual Report on Form 10-K for the year ending December 31, 2018. We will also be required to include additional information regarding executive compensation and include a nonbinding advisory vote on executive compensation in our 2019 proxy statement. These additional reporting requirements, among others, may increase our legal and financial compliance costs and cause management and other personnel to divert attention from operational and other business matters to devote substantial time to public company reporting requirements. In addition, if we are not able to comply with changing legal requirements in a timely manner, the market price of our stock could decline and we could be subject to sanctions or investigations by the stock exchange on which our common stock is listed, the SEC, or other regulatory authorities, which would require additional financial and management resources.

Failure to develop and maintain adequate financial controls could cause us to have material weaknesses, which could adversely affect our operations and financial position.

As previously reported, in the first quarter of 2014, we identified a material weakness in internal controls over the accounting for leasing transactions which resulted in the identification of a material error in the accounting for our headquarters lease executed in May 2005. We might in the future discover other material weaknesses that require remediation. In addition, an internal control system, no matter how well-designed, cannot provide absolute assurance that misstatements due to error or fraud will not occur or that all control issues and instances of fraud will be detected. If we are not able to comply with the requirements of Section 404 of the Sarbanes-Oxley Act in a timely manner, or if we are unable to maintain proper and effective internal controls, we might not be able to produce timely and accurate financial statements. If that were to happen, the market price of our stock could decline and we could be subject to sanctions or investigations by the stock exchange on which our common stock is listed, the SEC, or other regulatory authorities.

Any failure to develop or maintain effective controls, or any difficulties encountered in their implementation or improvement, could harm our operating results or cause us to fail to meet our reporting obligations. Any failure to implement and maintain effective internal controls also could adversely affect the results of periodic management evaluations regarding the effectiveness of our internal control over financial reporting that we are required to include in our periodic reports filed with the SEC under Section 404 of the Sarbanes-Oxley Act. Ineffective disclosure controls and procedures or internal control over financial reporting could also cause investors to lose confidence in our reported financial and other information, which would likely have a negative effect on the trading price of our common stock. Implementing any appropriate changes to our internal controls may require specific compliance training of our directors, officers, and employees, entail substantial costs in order to modify our existing accounting systems, and take a significant period of time to complete. Such changes may not be effective, however, in maintaining the adequacy of our internal controls, and any failure to maintain that adequacy, or consequent inability to produce accurate financial statements on a timely basis, could increase our operating costs and could materially impair our ability to operate our business. In the event that we are not able to demonstrate compliance with Section 404 of the Sarbanes-Oxley Act in a timely manner, that our internal controls are perceived as inadequate, or that we are unable to produce timely or accurate financial statements, investors may lose confidence in our operating results and our stock price could decline.

While we remain an emerging growth company, we cannot be certain if the reduced disclosure requirements applicable to emerging growth companies will make our common stock less attractive to investors.

We anticipate we will no longer qualify as an emerging growth company as of December 31, 2018. Under the JOBS Act, emerging growth companies can delay adopting new or revised accounting standards until such time as those standards apply to private companies. We have irrevocably elected not to avail ourselves of this exemption from new or revised accounting standards and, therefore, we continue to be subject to the same new or revised accounting standards as other public companies that are not emerging growth companies.

For as long as we continue to be an emerging growth company, we may take advantage of certain other exemptions from various reporting requirements that are applicable to other public companies including, but not limited to, reduced disclosure obligations regarding executive compensation in our periodic reports and proxy statements, exemptions from the requirements of holding a nonbinding advisory vote on executive compensation and stockholder approval of any golden parachute payments not previously approved, and exemptions from the requirements of auditor attestation reports on the effectiveness of our internal control over financial reporting. We cannot predict if investors will find our common stock less attractive while we rely on these exemptions. If some investors find our common stock less attractive as a result, there may be a less active trading market for our common stock and our stock price may be more volatile.

Provisions in our restated certificate of incorporation and amended and restated bylaws and Delaware law might discourage, delay, or prevent a change in control of our company or changes in our management and, therefore, depress the trading price of our common stock.

Provisions of our certificate of incorporation and bylaws and Delaware law might discourage, delay, or prevent a merger, acquisition, or other change in control that stockholders consider favorable, including transactions in which you might otherwise receive a premium for your shares of our common stock. These provisions might also prevent or frustrate attempts by our stockholders to replace or remove our management. These provisions include:

- limitations on the removal of directors;
- advance notice requirements for stockholder proposals and nominations;
- limitations on the ability of stockholders to call special meetings;
- the inability of stockholders to act by written consent;
- the inability of stockholders to cumulate votes at any election of directors;
- the classification of our board of directors into three classes with only one class, representing approximately one-third of our directors, standing for election at each annual meeting; and
- the ability of our board of directors to make, alter or repeal our bylaws.

Our Board of Directors has the ability to designate the terms of and issue new series of preferred stock without stockholder approval. In addition, Section 203 of the Delaware General Corporation Law prohibits a publicly held Delaware corporation from engaging in a business combination with an interested stockholder, generally a person which together with its affiliates owns, or within the last three years has owned, 15% of our voting stock, for a period of three years after the date of the transaction in which the person became an interested stockholder, unless the business combination is approved in a prescribed manner.

The existence of the foregoing provisions and anti-takeover measures could limit the price that investors are willing to pay in the future for shares of our common stock. They could also deter potential acquirers of our company, thereby reducing the likelihood that you could receive a premium for your common stock in an acquisition.

If securities or industry analysts do not publish research or reports about our business, or publish inaccurate or unfavorable research or reports about our business, our stock price and trading volume could decline.

The trading market for our common stock depends, to some extent, on the research and reports that securities or industry analysts publish about us and our business. We do not have any control over these analysts. If one or more of the analysts who cover us downgrade our common stock or change their opinion of our common stock, our stock price would likely decline. If one or more of these analysts cease coverage of our company or fail to regularly publish reports on us, we could lose visibility in the financial markets, which could cause our stock price or trading volume to decline.

Item 6. EXHIBITS.

Incorporated by Reference

(Unless Otherwise Indicated)

Exhibit Number	Exhibit Title	Form	File	Exhibit	Filing Date
31.1	<u>Certification of the President and Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.</u>	—	—	—	Filed herewith
31.2	<u>Certification of the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.</u>	—	—	—	Filed herewith
32.1	<u>Certification of the President and Chief Executive Officer and the Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.</u>	—	—	—	Filed herewith
101.INS	XBRL Instance Document.	—	—	—	Filed herewith
101.SCH	XBRL Taxonomy Extension Schema Document.	—	—	—	Filed herewith
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document.	—	—	—	Filed herewith
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document.	—	—	—	Filed herewith
101.LAB	XBRL Taxonomy Extension Label Linkbase Document.	—	—	—	Filed herewith
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document.	—	—	—	Filed herewith

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.

Date: November 2, 2018

Benefitfocus, Inc.

By: /s/ Jonathon E. Dussault
Jonathon E. Dussault
Chief Financial Officer
(Principal financial and accounting officer)