

HEALTHEQUITY INC  
Form 10-Q  
September 07, 2017

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

Form 10-Q

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

For the quarterly period ended July 31, 2017

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

HEALTHEQUITY,  
INC.

(Exact name of registrant as specified in its charter)

Delaware 7389 52-2383166  
(State or other jurisdiction of (Primary Standard Industrial (I.R.S. Employer  
incorporation or organization) Classification Code Number) Identification Number)  
15 West Scenic Pointe Drive  
Suite 100  
Draper, Utah 84020  
(Address of principal executive offices) (Zip code)

(801) 727-1000  
(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 ("Exchange Act") during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):  
Large accelerated filer  Accelerated filer   
Non-accelerated filer  (Do not check if a smaller reporting company) Smaller reporting company

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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 August 31, 2017, there were 60,488,740 shares of the registrant's common stock outstanding.

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HealthEquity, Inc. and subsidiaries  
Form 10-Q quarterly report

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## Part I. Financial information

## Item 1. Financial statements

## HealthEquity, Inc. and subsidiaries

## Condensed consolidated balance sheets (unaudited)

(in thousands, except par value)	July 31, 2017	January 31, 2017
<b>Assets</b>		
<b>Current assets</b>		
Cash and cash equivalents	\$ 169,721	\$ 139,954
Marketable securities, at fair value	40,581	40,405
Total cash, cash equivalents and marketable securities	210,302	180,359
Accounts receivable, net of allowance for doubtful accounts as of July 31, 2017 and January 31, 2017 were \$45 and \$75, respectively	20,904	17,001
Inventories	339	592
Other current assets	8,078	2,867
Total current assets	239,623	200,819
Property and equipment, net	6,080	5,170
Intangible assets, net	73,827	65,020
Goodwill	4,651	4,651
Deferred tax asset	5,054	1,615
Other assets	1,709	1,861
Total assets	\$ 330,944	\$ 279,136
<b>Liabilities and stockholders' equity</b>		
<b>Current liabilities</b>		
Accounts payable	\$ 1,594	\$ 3,221
Accrued compensation	6,520	8,722
Accrued liabilities	4,829	3,760
Total current liabilities	12,943	15,703
<b>Long-term liabilities</b>		
Other long-term liabilities	2,067	1,456
Deferred tax liability	—	37
Total long-term liabilities	2,067	1,493
Total liabilities	15,010	17,196
Commitments and contingencies (see note 6)		
<b>Stockholders' equity</b>		
Preferred stock, \$0.0001 par value, 100,000 shares authorized, no shares issued and outstanding as of July 31, 2017 and January 31, 2017, respectively	—	—
Common stock, \$0.0001 par value, 900,000 shares authorized, 60,399 and 59,538 shares issued and outstanding as of July 31, 2017 and January 31, 2017, respectively	6	6
Additional paid-in capital	247,255	232,114
Accumulated other comprehensive loss	(195)	(165)
Accumulated earnings	68,868	29,985
Total stockholders' equity	315,934	261,940
Total liabilities and stockholders' equity	\$ 330,944	\$ 279,136

The accompanying notes are an integral part of the unaudited condensed consolidated financial statements.

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HealthEquity, Inc. and subsidiaries  
Condensed consolidated statements of operations and  
comprehensive income (unaudited)

(in thousands, except per share data)	Three months ended July 31,		Six months ended July 31,	
	2017	2016	2017	2016
Revenue:				
Service revenue	\$22,809	\$18,835	\$45,296	\$37,829
Custodial revenue	21,285	14,779	40,604	28,590
Interchange revenue	12,785	10,571	26,400	21,779
Total revenue	56,879	44,185	112,300	88,198
Cost of revenue:				
Service costs	14,998	10,539	30,573	21,796
Custodial costs	2,785	2,394	5,586	4,750
Interchange costs	3,294	2,698	6,598	5,417
Total cost of revenue	21,077	15,631	42,757	31,963
Gross profit	35,802	28,554	69,543	56,235
Operating expenses:				
Sales and marketing	5,194	4,190	9,815	8,373
Technology and development	6,797	4,993	13,039	9,618
General and administrative	6,234	5,550	12,102	10,124
Amortization of acquired intangible assets	1,082	1,082	2,165	2,131
Total operating expenses	19,307	15,815	37,121	30,246
Income from operations	16,495	12,739	32,422	25,989
Other expense:				
Other expense, net	(38)	(37)	(128)	(678)
Total other expense	(38)	(37)	(128)	(678)
Income before income taxes	16,457	12,702	32,294	25,311
Income tax provision (benefit)	(489)	)4,469	1,319	9,005
Net income	\$16,946	\$8,233	\$30,975	\$16,306
Net income per share:				
Basic	\$0.28	\$0.14	\$0.52	\$0.28
Diluted	\$0.27	\$0.14	\$0.50	\$0.27
Weighted-average number of shares used in computing net income per share:				
Basic	60,173	58,246	59,955	58,035
Diluted	61,765	59,651	61,604	59,501
Comprehensive income:				
Net income	\$16,946	\$8,233	\$30,975	\$16,306
Other comprehensive gain (loss):				
Unrealized gain (loss) on available-for-sale marketable securities, net of tax	(4)	)27	(30)	(12)
Comprehensive income	\$16,942	\$8,260	\$30,945	\$16,294

The accompanying notes are an integral part of the unaudited condensed consolidated financial statements.

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HealthEquity, Inc. and subsidiaries  
Condensed consolidated statements of cash flows (unaudited)

(in thousands)	Six months ended	
	July 31, 2017	2016
Cash flows from operating activities:		
Net income	\$30,975	\$16,306
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	7,136	6,125
Amortization of deferred financing costs and other	27	36
Deferred taxes	4,699	(738 )
Stock-based compensation	6,803	4,331
Changes in operating assets and liabilities:		
Accounts receivable	(3,873 )	(2,373 )
Inventories	253	(79 )
Other assets	(4,073 )	(5,245 )
Accounts payable	(1,495 )	(1,069 )
Accrued compensation	(2,202 )	(3,423 )
Accrued liabilities	900	827
Other long-term liabilities	611	840
Net cash provided by operating activities	39,761	15,538
Cash flows from investing activities:		
Purchases of intangible member assets	(6,515 )	—
Acquisition of a business	(3,000 )	—
Purchases of marketable securities	(224 )	(177 )
Purchase of property and equipment	(2,161 )	(1,250 )
Purchase of software and capitalized software development costs	(5,166 )	(3,960 )
Net cash used in investing activities	(17,066 )	(5,387 )
Cash flows from financing activities:		
Proceeds from exercise of common stock options	7,072	1,128
Tax benefit from exercise of common stock options	—	14,249
Net cash provided by financing activities	7,072	15,377
Increase in cash and cash equivalents	29,767	25,528
Beginning cash and cash equivalents	139,954	83,641
Ending cash and cash equivalents	\$169,721	\$109,169
Supplemental disclosures of non-cash investing and financing activities:		
Purchases of property and equipment included in accounts payable or accrued liabilities at period end	\$53	\$379
Purchases of software and capitalized software development costs included in accounts payable or accrued liabilities at period end	69	116
Purchases of intangible member assets accrued at period end	270	—
Exercise of common stock options receivable	1,017	—

The accompanying notes are an integral part of the unaudited condensed consolidated financial statements.

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HealthEquity, Inc. and subsidiaries

Notes to condensed consolidated financial statements (unaudited)

Note 1. Summary of business and significant accounting policies

HealthEquity, Inc. was incorporated in the state of Delaware on September 18, 2002. The Company offers a full range of innovative solutions for managing health care accounts (Health Savings Accounts, Health Reimbursement Arrangements, and Flexible Spending Accounts) for health plans, insurance companies, and third-party administrators.

In February 2006, HealthEquity, Inc. received designation by the U.S. Department of Treasury to act as a passive non-bank custodian, which allows HealthEquity, Inc. to hold custodial assets in trust for individual account holders. On July 24, 2017, HealthEquity, Inc. received designation by the U.S. Department of Treasury to act as both a passive and non-passive non-bank custodian, which allows HealthEquity, Inc. to hold custodial assets in trust for individual account holders and use discretion to direct investment of such assets held in trust. As passive and non-passive non-bank custodian according to the Internal Revenue Code ("IRC") 1.408-2(e)(5)(ii)(B), the Company must maintain net worth (assets minus liabilities) greater than 2% of passive custodial funds held in trust at each year-end and 4% of the non-passive custodial funds held in trust at each year-end in order to take on additional custodial assets.

Principles of consolidation—The condensed consolidated financial statements include the accounts of HealthEquity, Inc. and its wholly owned subsidiaries, HealthEquity Trust Company, HEQ Insurance Services, Inc., HealthEquity Advisors, LLC and HealthEquity Retirement Services, LLC (collectively referred to as, the "Company").

The Company has a 22% ownership interest in a limited partnership for investment in and the management of early stage companies in the healthcare industry, such partnership is accounted for using the equity method of accounting. The investment was approximately \$206,000 as of July 31, 2017 and is included in other assets on the accompanying condensed consolidated balance sheet.

The Company has a 2% ownership interest in a limited partnership that engages in the development of technology-based financial healthcare products. The Company determined there was no significant influence and therefore the investment was accounted for using the cost method of accounting. The investment was \$500,000 as of July 31, 2017 and is included in other assets on the accompanying condensed consolidated balance sheet.

Acquisitions of businesses are accounted for as business combinations, and accordingly, the results of operations of acquired businesses are included in the consolidated financial statements from the date of acquisition. All significant intercompany balances and transactions have been eliminated.

Basis of presentation—The accompanying condensed consolidated financial statements as of July 31, 2017 and for the three and six months ended July 31, 2017 and 2016 are unaudited and have been prepared in conformity with accounting principles generally accepted in the United States of America ("GAAP") and the applicable rules and regulations of the Securities and Exchange Commission ("SEC") regarding interim financial reporting. In the opinion of management, the interim data includes all adjustments, consisting only of normal recurring adjustments, necessary for a fair presentation of the results for the interim periods. Certain information and note disclosures normally included in annual financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to such rules and regulations. Therefore, these condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes included in the Company's Annual Report on Form 10-K for the year ended January 31, 2017. The fiscal year-end condensed consolidated balance sheet data was derived from audited financial statements, but does not include all disclosures required by GAAP.

Recent adopted accounting pronouncements—In March 2016, the Financial Accounting Standards Board (the "FASB") issued Accounting Standards Update ("ASU") 2016-09, Improvements to Employee Share-Based Payment Accounting. This ASU requires excess tax benefits and tax deficiencies to be recognized in the statement of operations and comprehensive income, which were previously presented as a component of stockholders' equity, on a prospective basis. In addition, any excess tax benefits that were not previously recognized because the related tax deduction had not reduced current taxes payable are to be recorded on a modified retrospective basis through a

cumulative-effect adjustment to retained earnings. This ASU also requires cash flows related to excess tax benefits to be classified as an operating activity on the statement of cash flows. Finally, this ASU no longer allows tax benefits to be included in the assumed proceeds when applying the treasury stock method for computing diluted

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HealthEquity, Inc. and subsidiaries

Notes to condensed consolidated financial statements (unaudited)

Note 1. Summary of business and significant accounting policies (continued)

weighted-average common shares outstanding, which results in share-based awards having a more dilutive effect on net income per diluted share.

The Company adopted this ASU during the three months ended April 30, 2017. As required by the standard, excess tax benefits recognized on stock-based compensation expense are reflected in our condensed consolidated statements of operations and comprehensive income as a component of the provision for income taxes rather than additional paid-in capital on a prospective basis. For the three and six months ended July 31, 2017, the Company recorded excess tax benefits in the amount of \$6.6 million and \$10.5 million, respectively, within our provision for income taxes in the condensed consolidated statements of operations and comprehensive income. In addition, any excess tax benefits that were not previously recognized because the related tax deduction had not reduced current taxes payable are to be recorded on a modified retrospective basis through a cumulative-effect adjustment to retained earnings as of the beginning of the period of adoption, which resulted in an increase of \$8.1 million to our retained earnings as of February 1, 2017.

For presentation requirements, the Company elected to prospectively apply the change in the presentation of excess tax benefits wherein excess tax benefits recognized on stock-based compensation expense are classified as operating activities on the condensed consolidated statements of cash flows for the three months ended April 30, 2017. Prior period classification of cash flows related to excess tax benefits were not adjusted. Further, the Company elected to adopt the forfeiture provisions of this ASU, which requires the Company to account for forfeitures as they occur. The adoption of the forfeiture provisions had no material impact on the condensed consolidated financial statements.

In January 2017, the FASB issued ASU 2017-01, Business Combinations: Clarifying the Definition of a Business, which provides a more robust framework to use in determining when a set of assets and activities is a business. This ASU is effective for fiscal years beginning December 15, 2017, and interim periods within those fiscal years. Early adoption is permitted. The new guidance is required to be applied on a prospective basis. The Company adopted this ASU during the three months ended July 31, 2017. The adoption had no material impact on the Company's condensed consolidated financial statements.

Recent issued accounting pronouncements—On May 28, 2014, the FASB issued ASU 2014-09, Revenue from Contracts with Customers, which requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. This ASU will replace most existing revenue recognition guidance in GAAP when it becomes effective. In July 2015, the FASB voted to defer the effective date to fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017, with early adoption beginning for fiscal years, and interim periods within those fiscal years, beginning after December 31, 2016. The standard permits the use of either the retrospective or cumulative effect transition method. In March 2016, the FASB issued ASU 2016-08, Principal versus Agent Considerations (Reporting Revenue Gross versus Net), which clarifies the guidance in determining revenue recognition as principal versus agent. In April 2016, the FASB issued ASU 2016-10, Identifying Performance Obligations and Licensing, which provides guidance in accounting for immaterial performance obligations and shipping and handling. In May 2016, the FASB issued ASU 2016-12, Narrow-Scope Improvements and Practical Expedients, which provides clarification on assessing the collectability criterion, presentation of sales taxes, measurement date for noncash consideration and completed contracts at transition. Finally, in December 2016, the FASB issued ASU 2016-20, Technical Corrections and Improvements to Topic 606, Revenue from Contracts with Customers, which makes minor corrections or minor improvements to the Codification that are not expected to have a significant impact. The foregoing amendments are effective for annual reporting periods beginning after December 15, 2017 and for interim reporting periods within such annual periods. The adoption of this guidance is not expected to have a material impact on the Company's revenue. The Company is still evaluating the impact of this guidance on sales commissions and activation costs. The Company will use the cumulative effect transition method and does not plan to early adopt.

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In January 2016, the FASB issued ASU 2016-01, Recognition and Measurement of Financial Assets and Liabilities. The amendments in this ASU revise an entity's accounting related to the classification and measurement of investments in equity securities and the presentation of certain fair value changes for financial liabilities measured at fair value. This ASU also amends certain disclosure requirements associated with the fair value of financial instruments. The amendments in this ASU are effective for annual periods, and interim periods within those annual

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HealthEquity, Inc. and subsidiaries

Notes to condensed consolidated financial statements (unaudited)

Note 1. Summary of business and significant accounting policies (continued)

periods, beginning after December 15, 2017. Early adoption is permitted for the presentation of certain fair value changes for financial liabilities measured at fair value. The Company does not plan to early adopt and is currently evaluating the potential effect of this ASU on the consolidated financial statements.

In February 2016, the FASB issued ASU No. 2016-02, Leases (ASC 842), which sets out the principles for the recognition, measurement, presentation and disclosure for both parties to a contract (i.e. lessees and lessors). ASC 842 supersedes the previous leases standard, ASC 840 leases. This ASU is effective for financial statements issued for reporting periods beginning after December 15, 2018 and requires a modified retrospective transition, and provides for certain practical expedients; early adoption is permitted. The Company does not plan to early adopt and is currently evaluating the potential effect of this ASU on the consolidated financial statements.

In June 2016, the FASB issued ASU 2016-13, Financial Instruments - Credit Losses: Measurement of Credit Losses on Financial Instruments, which requires financial assets measured at amortized cost be presented at the net amount expected to be collected. This ASU is effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. Early adoption is permitted. The Company does not plan to early adopt this ASU. The Company believes the adoption of this ASU will have an immaterial impact on its consolidated financial statements.

In August 2016, the FASB issued ASU 2016-15, Statement of Cash Flows (Topic 230), which provides guidance on the classification of certain cash receipts and cash payments. This ASU is effective for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. Early adoption is permitted. The Company does not plan to early adopt this ASU. The Company believes the adoption of this ASU will have an immaterial impact on its consolidated financial statements.

In October 2016, the FASB issued ASU 2016-16, Income Taxes (Topic 740) - Intra-Entity Transfers of Assets Other Than Inventory, which updates the accounting for the income tax consequences of intra-entity transfers of assets other than inventory. This ASU is effective for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. Early adoption is permitted. The Company is currently evaluating the timing of adoption and the potential effect of this ASU on the consolidated financial statements.

In January 2017, the FASB issued ASU 2017-04, Simplifying the Test for Goodwill Impairment, which removes step two from the goodwill impairment test. As a result, an entity should perform its annual goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount and should recognize an impairment charge for the amount by which the carrying amount exceeds the reporting units' fair value. This ASU is effective for fiscal years beginning December 15, 2019, and interim periods within those fiscal years. Early adoption is permitted. The Company is currently evaluating the timing of adoption; however it does not believe this ASU will have material impact on the Company's consolidated financial statements.

In May 2017, the FASB issued ASU 2017-09, Compensation—Stock Compensation (Topic 718): Scope of Modification Accounting, which provides guidance about changes to the terms or conditions of a share-based payment award. This ASU is effective for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. Early adoption is permitted, including adoption in any interim period. The standard should be applied prospectively to an award modified on or after the adoption date. The Company does not expect the adoption of this ASU to have a significant impact on its condensed consolidated financial statements.

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HealthEquity, Inc. and subsidiaries

Notes to condensed consolidated financial statements (unaudited)

Note 2. Net income per share

The following table sets forth the computation of basic and diluted net income per share:

(in thousands, except per share data)	Three months ended July 31,		Six months ended July 31,	
	2017	2016	2017	2016
Numerator (basic and diluted):				
Net income	\$16,946	\$8,233	\$30,975	\$16,306
Denominator (basic):				
Weighted-average common shares outstanding	60,173	58,246	59,955	58,035
Denominator (diluted):				
Weighted-average common shares outstanding	60,173	58,246	59,955	58,035
Weighted-average dilutive effect of stock options and restricted stock units	1,592	1,405	1,649	1,466
Diluted weighted-average common shares outstanding	61,765	59,651	61,604	59,501
Net income per share:				
Basic	\$0.28	\$0.14	\$0.52	\$0.28
Diluted	\$0.27	\$0.14	\$0.50	\$0.27

For the three months ended July 31, 2017 and 2016, approximately 771,000 and 2.0 million shares, respectively, attributable to stock options and restricted stock units were excluded from the calculation of diluted earnings per share as their inclusion would have been anti-dilutive.

For the six months ended July 31, 2017 and 2016, approximately 670,000 and 2.2 million shares, respectively, attributable to stock options and restricted stock units were excluded from the calculation of diluted earnings per share as their inclusion would have been anti-dilutive.

Note 3. Cash, cash equivalents and marketable securities

Cash, cash equivalents and marketable securities as of July 31, 2017 consisted of the following:

(in thousands)	Cost basis	Gross unrealized gains	Gross unrealized losses	Fair value
Cash and cash equivalents	\$169,721	\$ —	\$ —	\$169,721
Marketable securities:				
Mutual funds	40,894	243	(556)	40,581
Total cash, cash equivalents and marketable securities	\$210,615	\$ 243	\$ (556)	\$210,302

Cash, cash equivalents and marketable securities as of January 31, 2017 consisted of the following:

(in thousands)	Cost basis	Gross unrealized gains	Gross unrealized losses	Fair value
Cash and cash equivalents	\$139,954	\$ —	\$ —	\$139,954
Marketable securities:				
Mutual funds	40,670	207	(472)	40,405
Total cash, cash equivalents and marketable securities	\$180,624	\$ 207	\$ (472)	\$180,359

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HealthEquity, Inc. and subsidiaries

Notes to condensed consolidated financial statements (unaudited)

Note 3. Cash, cash equivalents and marketable securities (continued)

The following table summarizes the cost basis and fair value of the marketable securities by contractual maturity as of July 31, 2017:

(in thousands)	Cost basis	Fair value
One year or less	\$25,495	\$25,448
Over one year and less than five years	15,399	15,133
Total	\$40,894	\$40,581

Unrealized losses from marketable securities are primarily attributable to change in interest rates. The Company does not believe any remaining unrealized losses represent other-than-temporary impairments based on the Company's evaluation of available evidence as of July 31, 2017. As of July 31, 2017, marketable securities with an unrealized loss position for more than twelve consecutive months were as follows:

(in thousands)	Less than one year		Greater than one year	
	Fair value	Unrealized losses	Fair value	Unrealized losses
Mutual funds	\$25,448	\$ (207 )	\$15,133	\$ (349 )

Note 4. Property and equipment

Property and equipment consisted of the following as of July 31, 2017 and January 31, 2017:

(in thousands)	July 31, 2017	January 31, 2017
Leasehold improvements	\$1,269	\$860
Furniture and fixtures	3,963	3,129
Computer equipment	8,140	7,194
Property and equipment, gross	13,372	11,183
Accumulated depreciation	(7,292 )	(6,013 )
Property and equipment, net	\$6,080	\$5,170

Depreciation expense for the three months ended July 31, 2017 and 2016 was \$647,000 and \$437,000, respectively, and \$1.3 million and \$884,000 for the six months ended July 31, 2017 and 2016, respectively.

Note 5. Intangible assets and goodwill

During the three months ended July 31, 2017, the Company acquired an HSA portfolio for \$6.8 million. The cost, including transaction costs, was allocated to acquired intangible member assets as of July 31, 2017. The Company has determined the acquired intangible member assets to have a useful life of 15 years. The assets will be amortized using the straight-line amortization method, which has been determined appropriate to reflect the pattern over which the economic benefits of existing member assets are realized.

To increase its product offering, during the three months ended July 31, 2017, the Company acquired the assets of BenefitGuard LLC, pursuant to a definitive asset purchase agreement, for a purchase price of \$3.0 million cash. BenefitGuard LLC is a 401(k) provider that offers 3(16) plan administrator and 3(21) named fiduciary services for 401(k) employer sponsors. The Company accounted for the acquisition of assets of BenefitGuard LLC as a purchase of a business under ASC 805. The preliminary purchase price allocation resulted in customer relationships, or other intangible assets, of \$3.0 million. The Company has determined the other intangible assets to have a useful life of 10 years. The asset will be amortized using the straight-line amortization method, which has been determined appropriate

to reflect the pattern over which the economic benefits will be realized. The financial impact of this acquisition, including pro forma financial results, was immaterial to the Company's consolidated statement of operations for the three and six months ended July 31, 2017.

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HealthEquity, Inc. and subsidiaries

Notes to condensed consolidated financial statements (unaudited)

## Note 5. Intangible assets and goodwill (continued)

During the three months ended July 31, 2017 and 2016, the Company capitalized software development costs of \$2.0 million and \$1.8 million, respectively, and \$4.2 million and \$3.7 million for the six months ended July 31, 2017 and 2016, respectively, related to significant enhancements and upgrades to its proprietary system.

The gross carrying amount and associated accumulated amortization of intangible assets were as follows as of July 31, 2017 and January 31, 2017:

(in thousands)	July 31, 2017	January 31, 2017
Amortized intangible assets:		
Capitalized software development costs	\$28,119	\$23,925
Software	7,726	7,041
Other intangible assets	3,000	—
Acquired intangible member assets	71,747	64,962
Intangible assets, gross	110,592	95,928
Accumulated amortization	(36,765 )	(30,908 )
Intangible assets, net	\$73,827	\$65,020

During the three months ended July 31, 2017 and 2016, the Company incurred and expensed a total of \$3.1 million and \$2.3 million, respectively, and \$5.9 million and \$4.3 million for the six months ended July 31, 2017 and 2016, respectively, in software development costs primarily related to the post-implementation and operation stages of its proprietary software.

Amortization expense for the three months ended July 31, 2017 and 2016 was \$3.0 million and \$2.7 million, respectively, and \$5.9 million and \$5.2 million for the six months ended July 31, 2017 and 2016, respectively.

There were no changes to the goodwill carrying value during the three and six months ended July 31, 2017 and 2016.

## Note 6. Commitments and contingencies

The Company's principal commitments and contingencies consist of a processing services agreement with a vendor, and obligations for office space, telephony services, data storage facilities, equipment and certain maintenance agreements under long-term, non-cancelable operating leases. These commitments as of January 31, 2017 are disclosed in the Company's consolidated financial statements included in its Annual Report on Form 10-K for the year ended January 31, 2017, and did not change materially during the three and six months ended July 31, 2017, except for the following:

On May 31, 2017, the Company entered into an amendment to its lease agreement, dated May 15, 2015, by and between the Company and its landlord to expand its current office space. The term of the lease will commence on January 1, 2018 and will expire on March 31, 2027. The Company will be responsible for payment of taxes and operating expenses for its portion of the building, in addition to an annual base rent in the initial amount of approximately \$513,000, with annual increases ranging from 2.5% to 3.1%.

Lease expense for office space for the three and six months ended July 31, 2017 was \$1.0 million, and \$2.1 million, respectively, and \$424,000 and \$1.0 million for the three and six months ended July 31, 2016, respectively. Expense for other lease agreements for the three and six months ended July 31, 2017 was \$106,000 and \$226,000, respectively, and \$84,000 and \$144,000 for the three and six months ended July 31, 2016, respectively.

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HealthEquity, Inc. and subsidiaries

Notes to condensed consolidated financial statements (unaudited)

Note 7. Indebtedness

On September 30, 2015, the Company entered into a new credit facility (the "Credit Agreement"). The Credit Agreement provides for a secured revolving credit facility in the aggregate principal amount of \$100.0 million for a term of five years. The proceeds of borrowings under the Credit Agreement may be used for general corporate purposes. No amounts have been drawn under the Credit Agreement as of July 31, 2017.

Borrowings under the Credit Agreement bear interest equal to, at the Company's option, a) an adjusted LIBOR rate or b) a customary base rate, in each case with an applicable spread to be determined based on the Company's leverage ratio as of the most recent fiscal quarter. The applicable spread for borrowing under the Credit Agreement ranges from 1.50% to 2.00% with respect to adjusted LIBOR rate borrowings and 0.50% to 1.00% with respect to customary base rate borrowings. Additionally, the Company pays a commitment fee ranging from 0.20% to 0.30% on the daily amount of the unused commitments under the Credit Agreement payable in arrears at the end of each fiscal quarter. The Company's material subsidiaries are required to guarantee the obligations of the Company under the Credit Agreement. The obligations of the Company and the guarantors under the Credit Agreement and the guarantees are secured by substantially all assets of the Company and the guarantors, subject to customary exclusions and exceptions. The Credit Agreement requires the Company to maintain a total leverage ratio of not more than 3.00 to 1.00 as of the end of each fiscal quarter and a minimum interest coverage ratio of at least 3.00 to 1.00 as of the end of each fiscal quarter. In addition, the Credit Agreement includes customary representations and warranties, affirmative and negative covenants, and events of default. The restrictive covenants include customary restrictions on the Company's ability to incur additional indebtedness; make investments, loans or advances; grant or incur liens on assets; engage in mergers, consolidations, liquidations or dissolutions; engage in transactions with affiliates; and make dividend payments. The Company was in compliance with these covenants as of July 31, 2017.

Note 8. Income taxes

The Company follows FASB Accounting Standards Codification 740-270, Income Taxes - Interim Reporting, for the computation and presentation of its interim period tax provision. Accordingly, management estimated the effective annual tax rate and applied this rate to the year-to-date pre-tax book income to determine the interim provision for income taxes. For the three months ended July 31, 2017, the Company recorded an income tax benefit of \$489,000 and for the six months ended July 31, 2017 an income tax provision of \$1.3 million. The resulting effective income tax rate was (3.0)% and 4.1%, compared with an effective income tax rate of 35.2% and 35.6% for the three and six months ended July 31, 2016. For the three and six months ended July 31, 2017, the net impact of discrete tax items caused a 38.8 and 31.7 percentage point decrease to the effective income tax rate primarily due to the excess tax benefit on stock-based compensation expense recognized in the provision for income taxes on the condensed consolidated statements of income, pursuant to the adoption of ASU 2016-09, Improvements to Employee Share-Based Payment Accounting. For the three and six months ended July 31, 2016, the net impact of discrete tax items was not material. The decrease in the effective income tax rate from the same period last year is primarily due to the excess tax benefit on stock-based compensation expense recognized in the provision for income taxes on the condensed consolidated statements of income during the three and six months ended July 31, 2017, pursuant to the adoption of ASU 2016-09.

As of July 31, 2017 and January 31, 2017, the Company's total gross unrecognized tax benefit was \$758,000 and \$674,000, respectively. As a result of ASU No. 2013-11, certain unrecognized tax benefits have been netted against their related deferred tax assets; therefore, no unrecognized tax benefit has been recorded as of July 31, 2017 and January 31, 2017. If recognized, \$640,000 of the total gross unrecognized tax benefits would affect the Company's effective income tax rate as of July 31, 2017.



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The Company files income tax returns with U.S. federal and state taxing jurisdictions and is not currently under examination with any jurisdiction. The Company remains subject to examination by federal and various state taxing jurisdictions for tax years after 2005.

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HealthEquity, Inc. and subsidiaries

Notes to condensed consolidated financial statements (unaudited)

## Note 9. Stock-based compensation

The following table shows a summary of stock-based compensation in the Company's condensed consolidated statements of operations and comprehensive income during the periods presented:

(in thousands)	Three months ended July 31,		Six months ended July 31,	
	2017	2016	2017	2016
Cost of revenue	\$692	\$421	\$1,183	\$796
Sales and marketing	526	353	842	566
Technology and development	862	446	1,534	803
General and administrative	1,714	1,289	3,244	2,166
Total stock-based compensation expense	\$3,794	\$2,509	\$6,803	\$4,331

## Stock options

The Company currently grants stock options under the 2014 Equity Incentive Plan (as amended and restated, the "Incentive Plan"). Under the terms of the Incentive Plan, the Company has the ability to grant incentive and nonqualified stock options. Incentive stock options may be granted only to Company team members. Nonqualified stock options may be granted to Company team members, directors and consultants. Such options are to be exercisable at prices, as determined by the board of directors, which must be equal to no less than the fair value of the Company's common stock at the date of the grant. Stock options granted under the Incentive Plan generally expire 10 years from the date of issuance, or are forfeited 90 days after termination of employment. Shares of common stock underlying stock options that are forfeited or that expire are returned to the Incentive Plan.

Stock option activity under the Company's equity incentive plans is as follows:

(in thousands, except for exercise prices and term)	Outstanding stock options					
	Number of options	Range of exercise prices	Weighted- average exercise price	Weighted- average contractual term (in years)	Aggregate intrinsic value	
Outstanding as of January 31, 2017	4,716	\$0.10 - 44.53	\$ 18.36	7.60	\$131,529	
Granted	412	\$41.28 - 51.44	\$ 42.64			
Exercised	(854)	)\$0.10 - 33.47	\$ 9.47			
Forfeited	(109)	)\$3.50 - 46.40	\$ 33.87			
Outstanding as of July 31, 2017	4,165	\$0.10 - 51.44	\$ 22.18	7.60	\$98,900	
Vested and expected to vest as of July 31, 2017	4,165		\$ 22.18	7.60	\$98,900	
Exercisable as of July 31, 2017	1,264		\$ 13.53	6.29	\$40,894	

The aggregate intrinsic value in the table above represents the difference between the estimated fair value of common stock and the exercise price of outstanding, in-the-money stock options.

The key input assumptions that were utilized in the valuation of the stock options granted during the periods presented:

	Three months ended July 31,		Six months ended July 31,		
	2017	2016	2017	2016	
Expected dividend yield	—	% —	% —	% —	%
Expected stock price volatility	37.79	% 38.29	% 37.79% - 38.01%	38.29% - 38.37%	
Risk-free interest rate	1.89	% 1.55	% 1.89% - 2.07%	1.33% - 1.55%	
Expected life of options	6.25 years	6.25 years	5.17 - 6.25 years	5.17 - 6.25 years	



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HealthEquity, Inc. and subsidiaries

Notes to condensed consolidated financial statements (unaudited)

## Note 9. Stock-based compensation (continued)

The determination of the fair value of stock options on the date of grant using an option pricing model is affected by the Company's stock price as well as assumptions regarding a number of complex and subjective variables. Expected volatility is determined using weighted average volatility of publicly traded peer companies. The Company expects that it will begin using its own historical volatility in addition to the volatility of publicly traded peer companies, as its share price history grows over time. The risk-free interest rate is determined by using published zero coupon rates on treasury notes for each grant date given the expected term on the options. The dividend yield of zero is based on the fact that the Company expects to invest cash in operations. The Company uses the "simplified" method to estimate expected term as determined under Staff Accounting Bulletin No. 110 due to the lack of sufficient option exercise history as a public company.

As of July 31, 2017, the weighted-average vesting period of non-vested awards expected to vest is approximately 2.2 years; the amount of compensation expense the Company expects to recognize for stock options vesting in future periods is approximately \$23.0 million.

## Restricted stock units

The Company grants restricted stock units ("RSU") to certain team members, officers, and directors under the 2014 Equity Incentive Plan. RSUs vest upon service-based criteria and performance-based criteria. Generally, service-based restricted stock units vest over a four-year period in equal annual installments commencing upon the first anniversary of the grant date. Performance-based restricted stock units ("PRSU") vest upon the achievement of certain financial criteria and cliff vest on January 31, 2020.

RSUs are valued based on the current value of the Company's closing stock price on the date of grant and stock-based compensation expense is recognized over the requisite service period. Stock-based compensation expense for PRSUs is recognized over the requisite service period based on the probable outcome of the achievement of the performance criteria.

A summary of the RSU activity is as follows:

(in thousands, except weight-average grant date fair value)	RSUs and PRSUs	Weighted-average grant date fair value
Outstanding as of January 31, 2017	10	\$ 26.93
Granted	397	43.34
Vested	(6	)43.81
Forfeitures	(1	)41.28
Outstanding as of July 31, 2017	400	\$ 42.90

Stock-based compensation expense related to RSUs, including PRSUs, for the three and six months ended July 31, 2017 was \$1.4 million and \$2.2 million, respectively. Total unrecorded stock-based compensation expense as of July 31, 2017 associated with RSUs was \$15.0 million, which is expected to be recognized over a weighted-average period of 3.2 years.

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HealthEquity, Inc. and subsidiaries

Notes to condensed consolidated financial statements (unaudited)

## Note 10. Fair value

Fair value measurements are made at a specific point in time, based on relevant market information. Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants at the measurement date. Accounting standards specify a hierarchy of valuation techniques based on whether the inputs to those valuation techniques are observable or unobservable. Observable inputs reflect data obtained from independent sources, while unobservable inputs reflect the Company's market assumptions. These two types of inputs have created the following fair value hierarchy:

Level 1—quoted prices in active markets for identical assets or liabilities;

Level 2—inputs, other than the quoted prices in active markets, that are observable either directly or indirectly; and

Level 3—unobservable inputs based on the Company's own assumptions.

Level 1 instruments are valued based on publicly available daily net asset values. Level 1 instruments consist primarily of highly liquid mutual funds.

The following tables summarize the assets measured at fair value on a recurring basis and indicates the level within the fair value hierarchy reflecting the valuation techniques utilized to determine fair value:

(in thousands)	July 31, 2017		
	Level 1	Level 2	Level 3

Marketable securities:

Mutual funds	\$40,581	\$ —	\$ —
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(in thousands)	January 31, 2017		
	Level 1	Level 2	Level 3

Marketable securities:

Mutual funds	\$40,405	\$ —	\$ —
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The carrying value of financial instruments including cash and cash equivalents and certain non-trade receivables approximate fair values as of July 31, 2017 due to the short-term nature of these instruments. The Company has classified cash and cash equivalents as Level 1 and certain non-trade receivables as Level 2 in the fair value hierarchy.

## Note 11. Subsequent event

On August 3, 2017, the Company acquired the rights to be the sole custodian of an HSA portfolio for \$3.3 million.

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Item 2. Management’s discussion and analysis of financial condition and results of operations

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our condensed consolidated financial statements and related notes appearing elsewhere in this Quarterly Report on Form 10-Q. The following discussion and analysis 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. Statements that are not purely historical are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended (the “Securities Act”), and Section 21E of the Securities Exchange Act of 1934, as amended (the “Exchange Act”). 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,” “plan,” “project,” “seek,” “should,” and similar expressions or variations intended to identify forward-looking statements. Such statements include, but are not limited to, statements concerning market opportunity, our future financial and operating results, investment strategy, sales and marketing strategy, management’s plans, beliefs and objectives for future operations, technology and development, economic and industry trends or trend analysis, expectations about seasonality, opportunity for portfolio purchases and other acquisitions, use of non-GAAP financial measures, operating expenses, anticipated income tax rates, capital expenditures, cash flows and liquidity. These statements are based on the beliefs and assumptions of our management based on information currently available to us. 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 identified below, and those discussed in the section titled “Risk factors” included in our Annual Report on Form 10-K for the year ended January 31, 2017 and in our other reports filed with the SEC. 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 events.

Overview

We are a leader and an innovator in the high-growth category of technology-enabled services platforms that empower consumers to make healthcare saving and spending decisions. Our platform provides an ecosystem where consumers can access their tax-advantaged healthcare savings, compare treatment options and pricing, evaluate and pay healthcare bills, receive personalized benefit and clinical information, earn wellness incentives, and make educated investment choices to grow their tax-advantaged healthcare savings.

The core of our ecosystem is the health savings account, or HSA, a financial account through which consumers spend and save long-term for healthcare on a tax-advantaged basis. We refer to the HSAs for which we serve as custodian as our HSA Members. We are the integrated HSA platform for 87 health plans, and over 34,000 employer clients. Our customers include individuals, employers of all sizes and health plans. We refer to our individual customers as our members, our health plan customers as our Health Plan Partners and our employer clients with more than 1,000 employees as our Employer Partners. Our Health Plan Partners and Employer Partners collectively constitute our Network Partners. Through our Network Partners, we have the potential to reach more than a third of the under-age 65 privately insured population in the United States.

Since our inception in 2002, we have been committed to developing technology solutions that empower healthcare consumers. In 2003, we began offering live 24/7/365 consumer support from health saving and spending experts. In 2005, we integrated HSAs with our first Health Plan Partner, and in 2006, we were authorized to act as an HSA custodian by the U.S. Department of the Treasury. In 2009, we integrated HSAs with multiple health plans of a single large employer, began delivering integrated wellness incentives through an HSA, and partnered with a private health insurance exchange as its preferred HSA partner. In 2011, we integrated HSAs, RAs, and investment accounts on one website, and in 2013, our registered investment advisor subsidiary began delivering HSA-specific investment advice online. In 2015, we launched our HSA Optimizer, which helps HSA members optimize their accounts based on their individual preferences and goals. In 2016, we launched a new feature which provides HSA account holders advance

access to employer contributions.

We generate revenue primarily from three sources: service revenue, custodial revenue and interchange revenue. We generate service revenue by providing monthly account services on our platform, primarily through multi-year contracts with our Network Partners that are typically three to five years in duration. We generate custodial revenue

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from custodial cash assets deposited with our FDIC-insured custodial depository bank partners and with our insurance company partner, and recordkeeping fees we earn in respect of mutual funds in which our members invest. We also generate interchange revenue from interchange fees that we earn on payments that our members make using our physical and virtual payment cards.

### Key factors affecting our performance

We believe that our performance and future success are driven by a number of factors, including those identified below. Each of these factors presents both significant opportunities and significant risks to our future performance. See the section entitled “Risk factors” included in our Annual Report on Form 10-K for the year ended January 31, 2017.

### Structural change in U.S. private health insurance

Substantially all of our revenue is derived from healthcare-related saving and spending by consumers in the United States, which is impacted by changes affecting the broader healthcare industry in the U.S. The healthcare industry has changed significantly in recent years, and we expect that significant changes will continue to occur that will result in increased participation in HDHPs and other consumer-centric health plans. In particular, we believe that continued growth in healthcare costs, and related factors will spur HDHP and HSA growth; however, the timing and impact of these and other developments in the healthcare industry are difficult to predict.

### Attracting and penetrating network partners

We created our business model to take advantage of the changing dynamics of the U.S. private health insurance market. Our model is based on a B2B2C distribution strategy, meaning that we rely on our Employer Partners and Health Plan Partners to reach potential members to increase the number of our HSA Members. Our success depends in large part on our ability to further penetrate our existing Network Partners by adding new HSA members from these partners and adding new Network Partners.

### Our innovative technology platform

We believe that innovations incorporated in our technology that enable consumers to make healthcare saving and spending decisions differentiate us from our competitors and drive our growth in revenue, HSA Members, Network Partners and custodial assets. Similarly, these innovations underpin our ability to provide a differentiated consumer experience in a cost-effective manner. For example, we are currently undertaking a significant update of our proprietary platform’s architecture, which will allow us to improve our transaction processing capabilities and related platform infrastructure to support continued account and transaction growth. We intend to continue to invest in our technology development to enhance our platform’s capabilities and infrastructure.

### Our “DEEP Purple” culture

The new healthcare consumer needs education and advice delivered by people as well as technology. We believe that our “DEEP Purple” culture which we define as driving excellence, ethics, and process while providing remarkable service, is a significant factor in our ability to attract and retain customers and to address nimbly opportunities in the rapidly changing healthcare sector. We make significant efforts to promote and foster DEEP Purple within our workforce. We invest in and intend to continue to invest in human capital through technology-enabled training, career development and advancement opportunities.

### Interest rates

As a non-bank custodian, we contract with FDIC-insured custodial depository bank partners and an insurance company partner to hold custodial cash assets on behalf of our members, and we generate a significant portion of our total revenue from interest rates offered by these partners. The contract terms range from three to five years and have either fixed or variable interest rates. As our custodial assets increase and existing agreements expire, we seek to enter into new contracts with FDIC-insured custodial depository bank partners, the terms of which are impacted by the then-prevailing interest rate environment. The diversification of deposits among bank partners and varied contract terms substantially reduces our exposure to short-term fluctuations in prevailing interest rates and mitigates the short-term impact of a sustained increase or decline in prevailing interest rates on our custodial revenue. A sustained decline in prevailing interest rates may negatively affect our business by reducing the size of the interest rate yield, or yield, available to us and thus the amount of the custodial revenue we can realize. Conversely, a sustained increase in prevailing interest rates would present us with an opportunity to increase our yield. An increase in our yield would



increase our custodial revenue as a percentage of total revenue. In addition, as our yield increases, we expect the spread to grow between the interest offered to us by our custodial depository

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bank partners and the interest we offer to our members, thus increasing our profitability. Changes in prevailing interest rates are driven by macroeconomic trends and government policies over which we have no control.

## Our competition and industry

Our direct competitors are HSA custodians. These are primarily state or federally chartered banks and other financial institutions for which we believe technology-based healthcare services are not a core business. Certain of our direct competitors have chosen to exit the market despite increased demand for these services. This has created, and we believe will continue to create, opportunities for us to leverage our technology platform and capabilities to increase our market share. However, some of our direct competitors are in a position, should they choose, to devote more resources to the development, sale and support of their products and services than we have at our disposal. In addition, numerous indirect competitors, including benefits administration technology and service providers, partner with banks and other HSA custodians to compete with us. Our Health Plan Partners may also choose to offer technology-based healthcare services directly, as some health plans have done. Our success depends on our ability to predict and react quickly to these and other industry and competitive dynamics.

## Regulatory environment

Federal law and regulations, including the Affordable Care Act, the Internal Revenue Code and IRS regulations, the Employment Retirement Income Security Act of 1974 and Department of Labor regulations, and public health regulations that govern the provision of health insurance, play a pivotal role in determining our market opportunity. Privacy and data security-related laws such as the Health Insurance Portability and Accountability Act of 1996, or HIPAA, and the Gramm-Leach-Bliley Act, laws governing the provision of investment advice to consumers, such as the Investment Advisers Act of 1940, or the Advisers Act, the USA PATRIOT Act, anti-money laundry laws, and the Federal Deposit Insurance Act, all play a similar role in determining our competitive landscape. In addition, state-level regulations also have significant implications for our business in some cases. For example, our subsidiary, HealthEquity Trust Company, is regulated by the Wyoming Division of Banking. Our ability to predict and react quickly to relevant legal and regulatory trends and to correctly interpret their market and competitive implications is important to our success.

## Our acquisition strategy

We have a successful history of acquiring complementary assets and businesses that strengthen our platform. We seek to continue this growth strategy and are regularly engaged in evaluating different opportunities. We have developed an internal capability to source, evaluate and integrate acquisitions that have created value for shareholders. We believe the nature of our competitive landscape provides a significant acquisition opportunity. Many of our competitors view their HSA businesses as non-core functions. We believe they will look to divest these assets and, in certain cases, be limited from making acquisitions due to depository capital requirements. We intend to continue to pursue acquisitions of complementary assets and businesses that we believe will strengthen our platform.

## Key financial and operating metrics

Our management regularly reviews a number of key operating and financial metrics to evaluate our business, determine the allocation of our resources, make decisions regarding corporate strategies and evaluate forward-looking projections and trends affecting our business. We discuss certain of these key financial metrics, including revenue, below in the section entitled “Key components of our results of operations.” In addition, we utilize other key metrics as described below.

## HSA members

The following table sets forth our HSA Members as of the periods indicated:

	July 31, 2017	July 31, 2016	% Change	January 31, 2017
HSA Members	2,899,646	2,300,007	26	% 2,746,132
Average HSA Members - Year-to-date	2,820,433	2,241,378	26	% 2,339,091
Average HSA Members - Quarter-to-date	2,858,087	2,270,896	26	% 2,519,382
HSA Members with investments	86,868	52,722	65	% 65,906

The number of our HSA Members is critical because our service revenue is driven by the amount we charge per HSA Member.



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The number of our HSA Members increased by approximately 600,000, or 26%, from July 31, 2016 to July 31, 2017, and by approximately 763,000, or 50%, from July 31, 2015 to July 31, 2016. During the three months ended July 31, 2017, the Company acquired the rights to be custodian of a portfolio of HSA Members, of which no HSA Members have transitioned to our platform as of July 31, 2017, and are not included in total HSA Members as of July 31, 2017. The increase in the number of our HSA Members in these periods was driven by the addition of new Network Partners and further penetration into existing Network Partners.

**Custodial assets**

The following table sets forth our custodial assets as of the periods indicated:

(in thousands, except percentages)	July 31, 2017	July 31, 2016	% Change	January 31, 2017
Custodial cash	\$4,502,841	\$3,658,245	23	% \$4,380,487
Custodial investments	871,524	542,331	61	% 658,580
Total custodial assets	\$5,374,365	\$4,200,576	28	% \$5,039,067
Average daily custodial cash - Year-to-date	\$4,429,299	\$3,560,117	24	% \$3,661,058
Average daily custodial cash - Quarter-to-date	\$4,448,090	\$3,602,152	23	% \$3,854,518

Our custodial assets, which are our HSA Members' assets for which we are the custodian, consist of the following components: (1) custodial cash deposits, which are deposits with our FDIC-insured custodial depository bank partners, (2) custodial cash deposits invested in an annuity contract with our insurance company partner and (3) members' investments in mutual funds through our custodial investment partner. Measuring our custodial assets is important because our custodial revenue is determined by the applicable account yields and average daily custodial cash balances.

Our total custodial assets increased by \$1.2 billion, or 28%, from July 31, 2016 to July 31, 2017. Our total custodial assets increased by \$1.6 billion, or 60%, from July 31, 2015 to July 31, 2016. The increase in total custodial assets in these periods was driven by additional custodial assets from our existing HSA Members and new custodial assets from new HSA Members added during the fiscal year. During the three months ended July 31, 2017, the Company acquired the rights to be custodian of a portfolio of HSA Members, of which no custodial assets have transitioned to our platform as of July 31, 2017.

**Adjusted EBITDA**

We define Adjusted EBITDA, which is a non-GAAP financial metric, as adjusted earnings before interest, taxes, depreciation and amortization, stock-based compensation expense, and certain other non-operating items. We believe that Adjusted EBITDA provides useful information to investors and analysts in understanding and evaluating our operating results in the same manner as our management and our board of directors because it reflects operating profitability before consideration of non-operating expenses and non-cash expenses, and serves as a basis for comparison against other companies in our industry.

The following table presents a reconciliation of net income, the most comparable GAAP financial measure, to Adjusted EBITDA for each of the periods indicated:

(in thousands)	Three months ended July 31,		Six months ended July 31,	
	2017	2016	2017	2016
Net income	\$16,946	\$8,233	\$30,975	\$16,306
Interest income	(179)	(128)	(336)	(248)
Interest expense	69	69	136	137
Income tax provision (benefit)	(489)	4,469	1,319	9,005
Depreciation and amortization	2,573	2,097	4,971	3,994
Amortization of acquired intangible assets	1,082	1,082	2,165	2,131
Stock-based compensation expense	3,793	2,509	6,803	4,331
Other (1)	148	96	328	790
Adjusted EBITDA	\$23,943	\$18,427	\$46,361	\$36,446

(1)

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For the three months ended July 31, 2017 and 2016, Other consisted of non-income-based taxes of \$102 and \$86, and acquisition-related costs of \$46 and \$10, respectively. For the six months ended July 31, 2017 and 2016, Other consisted of non-income based taxes of \$190 and \$172, acquisition-related costs of \$84 and \$595, and other costs of \$54 and \$23, respectively.

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The following table sets forth our Adjusted EBITDA:

(in thousands, except percentages)	Three months ended July 31,				Six months ended July 31,				
	2017	2016	\$ Change	% Change	2017	2016	\$ Change	% Change	
Adjusted EBITDA	\$23,943	\$18,427	\$ 5,516	30	%\$46,361	\$36,446	\$ 9,915	27	%
As a percentage of revenue	42	%42	%		41	%41	%		

Our Adjusted EBITDA increased by \$5.5 million, or 30%, from \$18.4 million for the three months ended July 31, 2016 to \$23.9 million for the three months ended July 31, 2017. The increase in Adjusted EBITDA was driven by the overall growth of our business, including a \$3.8 million, or 29%, increase in income from operations.

Our Adjusted EBITDA increased by \$9.9 million, or 27%, from \$36.4 million for the six months ended July 31, 2016 to \$46.4 million for the six months ended July 31, 2017. The increase in Adjusted EBITDA was driven by the overall growth of our business, including a \$6.4 million, or 25%, increase in income from operations.

Our use of Adjusted EBITDA has limitations as an analytical tool, and it should not be considered in isolation or as a substitute for analysis of our results as reported under GAAP.

Key components of our results of operations

#### Revenue

We generate revenue from three primary sources: service revenue, custodial revenue and interchange revenue.

**Service revenue.** We earn service revenue from the fees we charge our Network Partners, employer clients and individual members for the administration services we provide in connection with the HSAs and RAs we offer. Our fees are generally based on a fixed tiered structure fixed for the duration of our agreement with the relevant Network Partner, which is typically three to five years, and are paid to us on a monthly basis. We recognize revenue on a monthly basis as services are rendered under our written service agreements.

**Custodial revenue.** We earn custodial revenue from our custodial assets deposited with our FDIC-insured custodial depository bank partners, our insurance company partner and our custodial investment partner. As a non-bank custodian, we deposit our cash custodial assets with our various bank partners pursuant to contracts that (i) have terms that range from three to five years, (ii) provide for a fixed or variable interest rate payable on the average daily cash balances deposited with the relevant bank partner, and (iii) have minimum and maximum required deposit balances. We earn custodial revenue on our cash custodial assets that is based on the interest rates offered to us by these bank partners. In addition, once a member's HSA cash balance reaches a certain threshold, the member is able to invest his or her HSA assets in mutual funds through our custodial investment partner. We receive a recordkeeping fee related to such investment custodial assets.

**Interchange revenue.** We earn interchange revenue each time one of our members uses one of our payment cards to make a qualified purchase. This revenue is collected each time a member "swipes" our payment card to pay a healthcare-related expense. We recognize interchange revenue monthly based on reports received from third parties, namely, the card-issuing bank and the card processor.

#### Cost of revenue

Cost of revenue includes costs related to servicing member accounts, managing customer and partner relationships and processing reimbursement claims. Expenditures include personnel-related costs, depreciation, amortization, stock-based compensation, common expense allocations (such as office rent, supplies, and other overhead expenses), new member and participant supplies, and other operating costs related to servicing our members. Other components of cost of revenue include interest paid to members on cash custodial assets and interchange costs incurred in connection with processing card transactions for our members.

**Service costs.** Service costs include the servicing costs described above. Additionally, for new accounts, we incur on-boarding costs associated with the new accounts, such as new member welcome kits, the cost associated with issuance of new payment cards and costs of marketing materials that we produce for our Network Partners.

**Custodial costs.** Custodial costs are comprised of interest we pay to our HSA Members and fees we pay to banking consultants whom we use to help secure agreements with our FDIC-insured custodial depository banking partners. We pay interest to HSA Members on a tiered basis. The interest rates we pay to HSA Members can be changed at any

time upon required notice, which is typically 30 days.

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**Interchange costs.** Interchange costs are comprised of costs we incur in connection with processing payment transactions initiated by our members. Due to the substantiation requirement on RA-linked payment card transactions, which is the requirement that we confirm each purchase involves a "qualified medical expense" as defined under applicable law, payment card costs are higher for RA card transactions. In addition to fixed per card fees, we are assessed additional transaction costs determined by the amount of the transaction.

### **Gross profit and gross margin**

Our gross profit is our total revenue minus our total cost of revenue, and our gross margin is our gross profit expressed as a percentage of our total revenue. Our gross margin has been and will continue to be affected by a number of factors, including the amount we charge our partners and members, interest rates, how many services we deliver per account, and payment processing costs per account. We expect our annual gross margin to remain relatively steady over the near term, although our gross margin could fluctuate from period to period depending on the interplay of these factors.

### **Operating expenses**

**Sales and marketing.** Sales and marketing expenses consist primarily of personnel and related expenses for our sales and marketing staff, including sales commissions for our direct sales force, external agent/broker commission expenses, marketing expenses, depreciation, amortization, stock-based compensation, and common expense allocations.

We expect our sales and marketing expenses to increase for the foreseeable future as we continue to increase the size of our sales and marketing organization and expand into new markets. On an annual basis, we expect our sales and marketing expenses to increase slightly as a percentage of our total revenue over the near term. Our sales and marketing expenses may fluctuate as a percentage of our total revenue from period to period due to the seasonality of our total revenue and the timing and extent of our sales and marketing expenses.

**Technology and development.** Technology and development expenses include personnel and related expenses for software engineering, information technology, and product development. Technology and development expenses also include outsourced software engineering services, the costs of operating our on-demand technology infrastructure, depreciation, amortization of capitalized software development costs, stock-based compensation, and common expense allocations.

We expect our technology and development expenses to increase for the foreseeable future due to higher amortization costs related to our planned capital expenditures to improve the architecture of our proprietary system. On an annual basis, we expect our technology and development expenses to remain unchanged as a percentage of our total revenue. Our technology and development expenses may fluctuate as a percentage of our total revenue from period to period due to the seasonality of our total revenue and the timing and extent of our technology and development expenses.

**General and administrative.** General and administrative expenses include personnel and related expenses, and professional fees incurred by our executive, finance, legal, compliance, and people departments. They also include depreciation, amortization, stock-based compensation and common expense allocations.

We expect our general and administrative expenses to increase for the foreseeable future due to the additional legal, compliance, accounting, insurance, investor relations and other public company costs that we incur as we continue to grow as a public company, as well as other costs associated with continuing to grow our business. Looking forward, on an annual basis we expect our general and administrative expenses to remain unchanged as a percentage of our total revenue over the near term. Our general and administrative expenses may fluctuate as a percentage of our total revenue from period to period due to the seasonality of our total revenue and the timing and extent of our general and administrative expenses.

**Amortization of acquired intangible assets.** Amortization of acquired intangible assets results from