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Profiting From the Remote-Learning Boom

- Colleges and Corporations Are Big Customers
- There's A Big Risk and A Big Reward

Profiting From the Remote-Learning Boom

Colleges and Corporations Are Big Customers

There's A Big Risk and A Big Reward

> *We like this distressed bond. Here's why:*
> *Your likelihood of earning*
> *A high return is bolstered by*
> *Strong prospects for e-learning.*
> *- Martin Fridson*

The first lawyer was 6 feet, 4 inches tall.

So was the next one… And the next.

The fourth lawyer, though, mixed it up a little bit. He was 6 feet, 5 inches.

All told, the plaintiff had brought a parade of 11 pro-basketball-player-sized attorneys to the 1985 court hearing – fully prepped to argue their case in front of Federal District Court Judge Maryanne Trump Barry (Donald Trump's big sister).

The 25-year-old defendant, John Katzman – sitting with his lone, 5-foot-5-inch-tall lawyer – felt distinctly intimidated.

"It was totally daunting," Katzman admitted afterward in a 2021 interview in Authority Magazine.

But "test hacker" Katzman wasn't about to kowtow to the world's largest standardized testing company, ETS (Educational Testing Services), creator of the Scholastic Aptitude Test (SAT), which had for decades been a dreaded rite of passage for high-schoolers applying to college.

For the previous four years, Katzman had been showing students how to beat the nation's most feared college entry exam. And ETS – a behemoth test-making organization described by The New York Times in 1997 as "as much multinational monopoly as nonprofit institution" – was determined to take him down.

Ever since he scored an exceptional 1500 (out of a possible perfect score of 1600) on the SAT in high school, Katzman had suspected the test was misleadingly described…

ETS had long claimed that you couldn't "coach" the SAT because it measured (unchanging) IQ. In a 1986 note to students on "How to Prepare for the SAT," the test writers cautioned that "drill and practice on sample test questions generally result in little effect on test scores" and the best preparation for the test was simply to "study widely."

But after acing the SAT and entering Princeton University, young Katzman smelled a RAT. "As I tutored more and more students, I realized that this is just a test of middle school math and English. There's nothing magical about it," he said. And soon, he arrived at an even more provocative conclusion: In his opinion, the SAT didn't measure IQ at all. It measured something far less lofty: how well you took the SAT.

Katzman then took what he viewed as the natural next step: Start a renegade study group that showed high-schoolers how to "hack" their SAT exams.

Katzman reached out to a few ex-ETS employees who were more than happy to share tricks of the trade. Turned out, the 1980s version of the SAT was cleverly constructed as a "trap" for the average student, a character that Katzman christened "Joe Bloggs." The key was to answer the easy questions the way Joe, the average student, would answer them... and then, answer the harder questions the way Joe wouldn't.

For kids who'd assumed they would never get into a "good" college because they weren't smart enough, "Joe Bloggs" was a godsend. Between fall 1981 and spring 1982, Katzman's tutoring business ballooned from 19 students to 41 – and spilled from his mom's Manhattan apartment into rented offices on New York City's Upper East Side.

Princeton Review – named after Katzman's alma mater – was born.

And ETS wasn't happy about it.

With reports flying that Princeton Review's test hacks could boost students' SAT scores by up to 200 points – potentially, the difference between Bumpkintown State U. and MIT – ETS went on the offensive, claiming that Katzman's tiny company had stolen official SAT questions and used them in its study guides.

Hence the 11 supersized lawyers – and the intimidating display in Maryanne Trump Barry's courtroom.

"I didn't think they were evil, just incompetent. And then they sued," Katzman recalled. "Their whole point was to put this kid out of business, and they invoked in me a kind of rage around their arrogance. They've never been held accountable for the damage they've done to the education system in this country, and they act so righteous. They wanted to put the person calling them out, out of business."

Katzman – short lawyer notwithstanding – refused to capitulate, dragging the lawsuit on for several more years until the two parties reached a settlement. He maintains that any "real SAT" questions used in his material got there by accident. And, in the meantime, the high-profile case put Princeton Review on the map.

"By suing me they got me a lot of press, and we quadrupled in size almost immediately," Katzman said. "About 75 articles, including one on the front page of The New York Times, were written about the case. That really launched the company. But it was incredibly stressful."

As Princeton Review's star rose – rolling out nationwide franchise locations and becoming the 106th fastest-growing business in the U.S. by 1988 – ETS began to lose public credibility, called out by scathing articles in Harper's and Rolling Stone magazines. By the early 1990s, the company had completely overhauled the SAT, eliminating most of the "trick" questions and no longer claiming it was an IQ test. And in an abrupt about-face from its earlier claims, it started promoting test prep (but only from an ETS-approved partner organization, Khan University).

Whether Katzman's SAT hacks really enhanced students' scores to the extent he claimed – later studies suggest that "reports may be greatly exaggerated" – there's no denying that his maverick approach changed the face of standardized testing.

And that was just the first industry he upended.

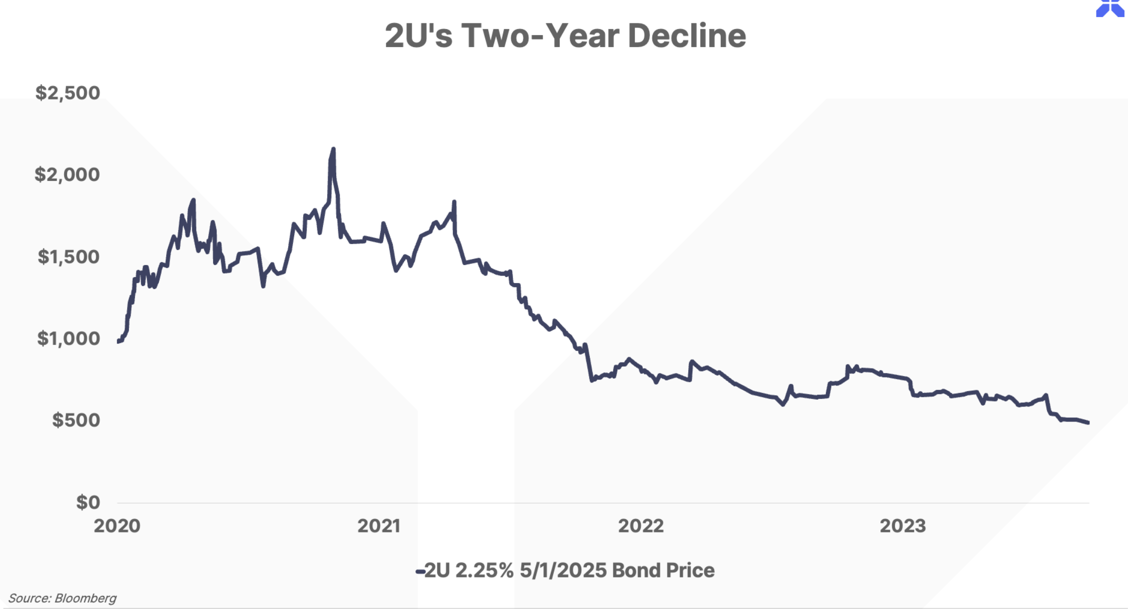
Next, Katzman went on to overhaul the education-industrial complex itself by pioneering the online college model.

And the (admittedly, somewhat controversial) online-education company Katzman founded is the one we'll be exploring in this month's issue...

Bond at a Glance

2U (Nasdaq: TWOU) is one of the largest and best-known online education companies in the world. The company operates in the U.S. and internationally and offers services to universities, corporations, and non-profit organizations. 2U generated revenue of $963 million in 2022 – up more than 30-fold since it went public in 2011 – with a 13% operating profit of $125 million. The business stagnated in 2023. Revenue is projected to be roughly the same as in 2022 and operating profit – without one-time gains – is likely to decline about 10%. TWOU's stock has fallen considerably, from $12 in February 2023 to $1.23 at the end of 2023.

And these convertible bonds have taken a hit as well. As you can see in the chart below, they once traded around $2,100 – *twice* the bond's face amount. After two years and a 75% decline, they now trade for $493, a little less than *half* of the bond's face amount.



Despite this dizzying drop in 2U's bond price over the last two years – or, more accurately, in part because of it – we believe 2U's 2.25% convertible bonds due May 1, 2025, offer good value because:

- 2U's business of providing online education and training is becoming increasingly important to businesses and governments around the world. Each year more jobs require computer skills and an understanding of artificial intelligence ("AI"), cybersecurity, or other technical knowledge. Google, IBM, and Verizon use 2U for training and enhancing the skills of their workforces.
- After missing its earnings targets over the last two quarters in 2023 (ending June 30 and September 30), management is laser-focused on profitability. In the fourth quarter it cut expenses that should result in more than $55 million of incremental profit starting in 2024.
- It also has plans for growth – the schedule of new programs that will be introduced in 2024 and 2025 is extensive.
- The company will try to convince investors to exchange the 2.25% convertible bonds maturing May 1, 2025, for bonds maturing a year or two later. 2U will need to offer bondholders a reward to accept this delayed investment. This reward might come in the form of a higher interest rate or a lower conversion price – and possibly a cash fee.
- Based on current market prices, the 2.25% convertible bond would yield roughly 26% per year if its maturity is pushed back two years to May 1, 2027.
- As we detail in the analysis, these are speculative bonds with a meaningful chance of gain, a possibility of bankruptcy, and a real chance of loss.

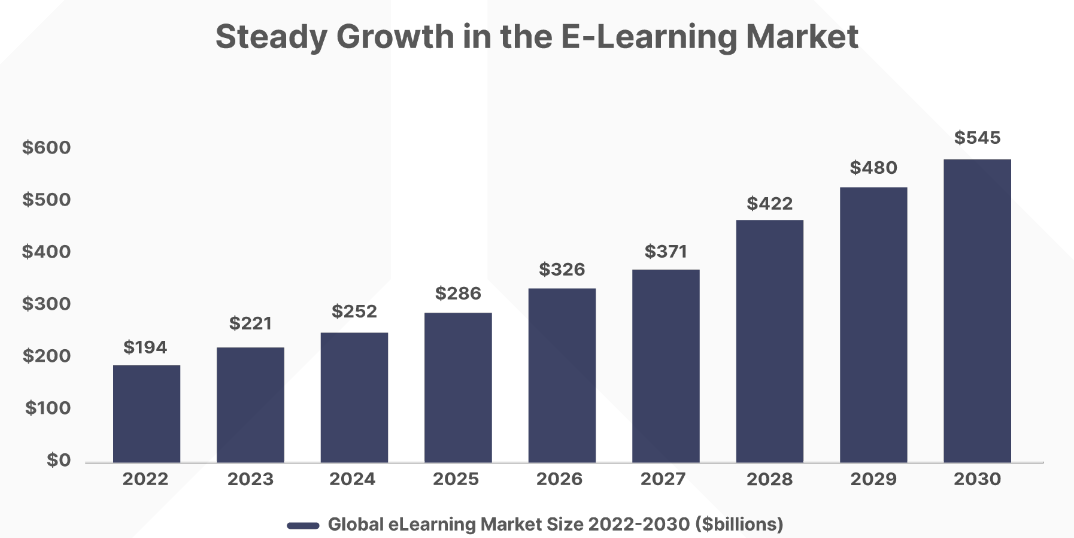
Growing Importance of E-Learning

The first question we ask about a company with bonds trading at such a deeply discounted price is whether it deserves to exist at all. We look to see if it holds good market share in a growing industry – or weak market share in a declining industry.

2U is one of the best-known providers of e-learning – serving up a wide range of online educational alternatives to people of all ages. We strongly believe that the long-term trend is 2U's friend.

E-learning providers, in general – and 2U in particular – were growing quickly even before the pandemic hit in 2020. Then, suddenly, remote learning became the norm in much of the world. Even with the sudden boom in online learning, only 2% to 3% of college and graduate degrees are earned remotely – providing a huge upside opportunity. Given the many advantages of remote learning (which we will discuss shortly) we believe that percentage will rise over time.

In addition, the overall online-education field is growing steadily. Demand for online professional training will increase now that using and understanding some technology has become a key part of almost all jobs. The demand for "upskilling" – providing employees additional competencies – is projected to increase over the long term.



Source: *Zion Market Research*

According to Zion Market Research, the global e-learning market size was $194 billion in 2022 and will grow to $545 billion by 2030 – a 180% increase. While different market-research firms define the online-education market differently – and include aspects of the industry beyond where 2U plans to operate – they all see at least a 15% annual growth rate in the overall market over the longer term. This leads us to a positive outlook for future growth.

Remote learning offers numerous advantages over the traditional in-class model:

- Flexible class schedules are more convenient for working people and for those with a family
- AI has made it easier and less expensive to translate lectures and course materials into any language – expanding availability to students around the world
- E-learning technologies like virtual reality, AI, and gamification make the learner's experience more personalized and enjoyable
- AI-based analysis can observe a student's interests and strengths and customize a program specifically suited to them
- It is more affordable than traditional in-class education – tuition is lower, there is no commuting cost, and no need for on-campus housing or textbooks
- This cost advantage expands the size of the potential market since it attracts students from a wider variety of economic backgrounds
- The easy accessibility of e-learning is ideally suited for professional development

2U's History and Business

After successfully launching Princeton Review, turning the standardized testing industry upside down – and writing a *New York Times* bestseller, *Cracking the SAT* – John Katzman left the test-prep business and started a new venture in 2008. Online learning was in its infancy at the time, and he saw an opportunity. 2U would be an "ed tech" company that partnered with universities to offer online versions of their in-person degrees.

Much like Katzman's tutoring business, 2U grew quickly. The company's first online degree program was for a teaching degree offered by the University of Southern California ("USC"), which later added more degree programs. In 2011, the year 2U went public (and a year before Katzman left to build another online education company, Noodle), Georgetown University added a BA program in nursing and the University of North Carolina added an MBA program. University of California, Berkeley, Yale University, and many other prestigious schools added graduate-degree programs over the next few years.

2U's model for partnering with a school is sensible. It sets up shared technology with each school, so that information can flow in both directions between them. Using 2U's Open edX platform, the school does everything it normally does for students who are on campus. It handles admissions and it provides course material, lectures (live and recorded), assignments, and grading. Professors are available to meet students online by video chat just as they are available for office hours on campus.

In exchange for a percentage of tuition revenue, 2U does everything else needed to get an online degree program started and keep it running. It markets the degree program, handles the administrative part of the college's admission process, schedules the online classes, and provides technical support to make sure all aspects of the student's degree program function smoothly. 2U offers a turnkey technical solution to its university partner in exchange for a 15% to 55% share of revenues – depending on the tier of services offered.

The business grew rapidly. From the time of its initial public offering of stock in 2011 through the end of 2016, yearly revenue rose from $30 million to $206 million. At that point, management decided to accelerate growth through acquisitions.

In 2017, 2U acquired GetSmarter, an online provider of short courses, for $103 million. The company had course partnerships with Harvard University, the Massachusetts Institute of Technology ("MIT"), England's University of Cambridge, and the three top universities in South Africa, where GetSmarter was based. With this acquisition, 2U expanded geographically and added courses not connected to a larger degree program.

Revenue doubled from $206 million in 2016 to $412 million in 2018. In 2019, 2U acquired Trilogy Education, which provided job-training boot camps. The rationale for the $750 million purchase was to penetrate the career-training market. The acquisition also expanded 2U's portfolio of university partners from 32 to 68 and turbocharged the company's growth. Management's goal was to reach $1 billion in revenue by 2021 – which at $946 million was close to that.

Until this point, 2U had worked behind the scenes to enable top schools to reach a broad, online audience. The company itself was largely unknown outside the academic world. This changed in June 2021, when 2U acquired a company called edX for $800 million. That company operated an e-learning platform and education marketplace created in 2012 by scientists at MIT and Harvard.

edX was well known in the academic community and also provided a variety of free courses that drove tens of millions of users to its online marketplace. With this move, 2U would no longer be a behind-the-scenes player, but now public facing, operating under the edX brand.

In addition to its brand recognition and large online following, edX expanded 2U's reach to provide:

- High-school and professional education courses
- MicroMasters programs that allow learners to build in bite-sized pieces skills and credits toward a Master's degree
- MicroBachelors programs, college-level courses that can be taken separately and combined toward an undergraduate degree
- Partnerships with GE, Microsoft, and Tech Mahindra (a large information and technology company in India) to provide subsidized online courses and guaranteed job interviews to underserved communities.

2U's Business Now

As a result of 2U's growth and acquisition, it now offers programs with a wide array of top-tier schools and corporate partners. Among the many, here are some well-known names:

Higher Learning	Corporate Partners
Brown University	Amazon Web Services
California Institute of Technology	Alphabet (Google)
Columbia University	IBM
Dartmouth College	Meta Platforms (Facebook)
Harvard University	Verizon
Howard University	
MIT	
London School of Economics	
University of Maryland	
Vanderbilt University	
Yale University	

As of September 30, 2U had 250 university and corporate partners offering more than 4,400 courses, 260 executive education programs, and 200 boot camps. In 2022, the edX educational platform attracted over 100 million visits.

The company business is divided into two segments: Degree Programs (undergraduate, Master's, and doctorate) and the Alternate Credential segment (professional training and courses unrelated to any specific degree programs).

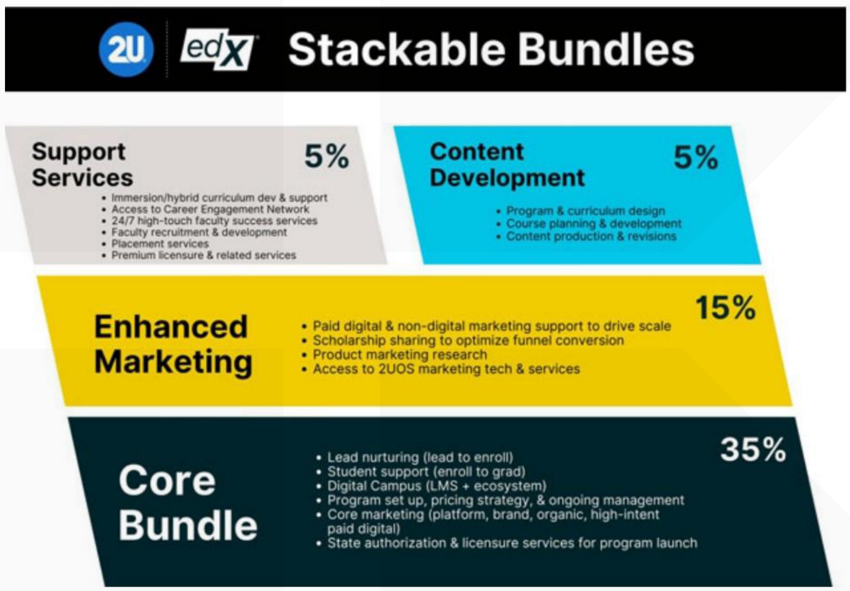
Degree Programs

Degree Programs are partnerships with non-profit schools and universities to offer a remote version of their traditional in-person classes. Students who enroll in these programs are on a path toward an undergraduate or graduate degree. They expect an academic experience on par with in-person learning. As mentioned, 2U provides the technology and services to enable the schools to offer an online equivalent of their degree programs.

2U's typical contract for a degree program with a college or non-profit runs for 10 to 15 years and has substantial penalties for early termination. Though amounts vary, adding a new degree program typically costs 2U between $5 million and $10 million up front. It usually takes a new degree program two to three years to attract enough students to become profitable.

In July 2023, 2U announced a new flexible-pricing system for university partners – at a higher price point but with more options for the schools. While 2U's share for the company's full package of services was set at 60% of total revenue received from students – just above the 55% high end of 2U's previous agreements – it also added its services in smaller, customized bundles. The "flex" contracts are for three to five years, instead of 10 to 15. These programs typically become profitable in the first or second year of operations.

The heart of the company's offering to schools is the Core Bundle. In exchange for a 35% share of program revenue, the company provides program design and management, recruiting, student technical support, and data analysis. For an additional share of revenue, 2U will provide enhanced marketing services, develop course materials, and offer additional support services.



2U evaluates each degree program on a regular basis – reviewing operating costs and expected revenue from enrollment. If a program is not profitable (usually for *both* parties), 2U and the school partner will agree to end the program early.

When this happens, 2U gets reimbursed for any expenses it incurred to create the program. It also receives some payment from the university for profits expected for the remainder of the contract period. For example, the company recently agreed to terminate most of its programs with USC – its first university partner – and a few smaller programs. USC cited, among other reasons, a mismatch between the high cost of the program and the career advancement ultimately provided to students. As of September 30, the company is expecting $145 million in termination payments over the next two years – $40 million of it from USC.

Alternative Credential Segment

The Alternative Credential segment provides executive education programs (running anywhere from two to 16 weeks) and technical, skills-based boot camps (running 16 to 24 weeks). 2U also offers flexible micro-credential programs – courses that stand alone or can also be stacked toward a degree. In addition to marketing these offerings directly to individuals, 2U also provides training material for businesses, nonprofit organizations, and governmental customers looking to increase labor productivity.

2U's revenue in this segment comes from a combination of student tuition and fees from employers seeking executive education programs. Two examples of corporate partnerships are:

- edX and Amazon Web Services ("AWS") launched a professional-certificate program in Cloud Solutions Architecture that prepares its learners for a test to become an associate AWS Certified Solutions Architect.
- Hewlett Packard partnered with 2U to offer a professional-certificate program that provides free training in game design and in programming. (This particular training series is available in English and Arabic, with more languages to follow.)

Making Adjustments With a Strategic Realignment Plan

Growth through acquisition helped the company increase revenue and expand its global footprint – but perhaps it moved too quickly. In 2022, growth began to falter. Key partners began to drop out, signups fell below where the company anticipated, and profits suffered. After roughly a year, the acquisition of edX proved to be disappointing.

It became clear that 2U paid too much for edX. It has written down the value of its edX assets, most recently by $164 million – currently carrying edX assets at roughly 30% of the original $800 million value it put on the books in 2021.

The fallout from the disappointing performance of edX and the loss of the USC business has led to management changes as well. On November 17, 2023, the company announced that CFO Paul Lalljie would replace CEO Chip Paucek, its co-founder who had held the top post since 2012.

Reacting to the company's sluggish results, in July 2022, 2U announced a strategic alignment plan to create one unified brand by placing all of its products on the edX platform.

As part of the plan, 2U took steps to reduce operating costs. It simplified its executive structure, cut the number of employees by 12%, reduced marketing expenses, and consolidated offices around the world to two locations – in Lanham, Maryland, and Cape Town, South Africa.

The company expects the strategic realignment plan to cost about $75 million to implement over the next few years but to save more than $50 million annually. Through September 30, 2023, the company has spent $52.2 million fulfilling the plan's goals.

Looking at Company Financials

Founded in 2008, 2U became a public company in 2011 and until 2023 was growing quickly. Revenue was $30 million in 2011 and rose each year, hitting $963 million in 2022.

The business generated its first operating profit – $16 million – in 2020. Profits increased to $67 million in 2021, $125 million in 2022, and $165 to $175 million expected for 2023. Adjusting for what we consider to be one-time payments from program closures (and therefore not real and ongoing revenue), we calculate 2023 profits at $110 million to $115 million – a decline of 10% to 15% from 2022's $125 million.

2U Financials

	Revenue	Operating Profit	Free Cash Flow
2011	$30	($23)	($21)
2012	$56	($20)	($22)
2013	$83	($23)	($18)
2014	$110	($22)	($16)
2015	$150	($19)	($13)
2016	$206	($11)	($2)
2017	$287	($11)	($19)
2018	$412	($17)	($15)
2019	$575	($24)	($80)
2020	$774	$16	($4)
2021	$946	$67	($34)
2022	$963	$125	$11
2023E	$970	$170	$25

Figures reported in $millions.

2U's expenses fall into four main categories:

- *Marketing and sales* – advertising costs to attract students and recruit employees (the largest category)
- *Curriculum and teaching* – the cost to licenses university brand names on executive education and boot camp programs
- *Service and support* – all costs of operating the edX platform and expenditures relating to enrolled students
- *Technology and content development* – for maintaining and improving the edX platform, website hosting, and software licensing

Segment Results

2U's Degree Programs segment is a mature and profitable business. It is affiliated with many top schools and generates high graduation rates, so it should continue to be an appealing alternative for schools and students. In the short term, revenue will decline with the loss of most USC programs and any other smaller agreements the company may choose to end because of poor performance. However, the company is adding new degree partners each year, and this business should grow slowly over the long term.

The Alternative Credential segment is currently losing money. It is growing, and it should benefit from long-term need for employee training and upskilling. There are reasons to believe that results in this segment will improve significantly in 2024.

The company plans to launch 80 new flex-degree programs in 2024. Each program requires roughly $500,000 to $1 million up front and becomes profitable during its first year. These are expected to add $120 million in annual revenue once up and running.

2U has 80 additional launches planned in 2025, with the same expected cost structure and revenue streams. The company expects that in 2024 revenues from the Alternate Credential segment will exceed those from the Degree Programs.

As mentioned above, in October 2023, the company announced that among other cuts it would trim its staff by 12% – expected to reduce expenses by $55 million a year, beginning in 2024 and going forward. The bulk of these savings fall in the Alternate Credentials segment, which management expects will become profitable in 2024.

Revenue and Profit by Segment

	Degree		Alternate Credit	
	Revenues	Operating Profit	Revenue	Operating Profit
2018	$348	$17	$63	$1
2019	$417	$6	$158	($30)
2020	$487	$50	$288	($34)
2021	$529	$127	$353	($60)
2022	$572	$181	$392	($56)
2023*	$398	$124	$293	($43)

*(9 months) | Reported in ($millions).

Balance Sheet

As of September 30, 2U had $41.1 million in cash and could borrow an additional $20 million from its bank lenders. Total debt amounts to $924 million, and is made up of bank borrowings and convertible bonds.

2U's Debt Profile	
Bank loan due 1/30/25 or 12/28/26	$377
Credit line due 1/30/25 or 12/28/26	$20
2.25% convertible bonds due 5/1/25	$380
4.5% convertible bonds due 5/1/30	$147
Total	$924

Reported in ($millions).

2U raised $127 million early in 2023, mostly from major shareholder Greenvale Capital, a large investment manager. The company used that money plus cash on hand to reduce its borrowing balance on its bank loans from $567 million to $377 million. In exchange for this partial repayment, the banks agreed to extend the maturity date on their loans from December 28, 2024, to December 28, 2026 – with an asterisk.

That asterisk is that the $377 million in bank borrowings will come due January 30, 2025 – *unless* the company extends the due date on most of the $380 million in 2.25% convertible bonds beyond their current maturity of May 1, 2025.

If *2U is able to extend at least $340 million of the 2.25% convertible bonds,* holders who exchange for them will get a new bond with a maturity date most likely in 2027. The company will need to give bondholders incentives to accept a later maturity.

The company and representatives for the bondholders have been negotiating those incentives, and the options include: the interest rate on the extended-date bond will be higher than the current 2.25% rate or it will be convertible into stock at a more attainable price than the current $27.28 per share.

If holders of $340 million or more of the current 2.25% bonds agree to a later maturity, the due date on 2U's bank borrowings will remain the newly established December 28, 2026. The longer due date on the bonds and bank loans would give the company more than two years to increase revenue and cut expenses. It will make it easier to refinance the bank debt when it comes due.

If *2U is not able to extend at least $340 million of the 2.25% convertible bonds,* 2U's bank debt will mature January 30, 2025 – three months *before* the convertible bonds are currently scheduled to be paid off.

There is a slim chance the company might be able to refinance the bank debt in January 2025 – *if* 2U's operating profits rise smartly over the next year. **If not, 2U might need to file for bankruptcy**. (We will discuss this shortly.) So both the company and bondholders have a powerful incentive to agree on an extension of the maturity of the 2.25% convertible bonds.

Valuation of the Business

We expect 2024's operating profit to come in between $125 million and $150 million. To arrive at this range, we start with the adjusted down $110 million profit number we see for 2023, allow for new programs that will increase revenue, and adjust for staff reductions that will cut costs.

In this chart we look at the market value of 2U's publicly traded competitors in the e-learning industry. We calculate the enterprise value ("EV") of each business by adding the market value of its stock to its debt. Then to arrive at the appropriate valuation multiple, we divide that amount by estimates of operating profit for 2023 and 2024.

Valuation of E-learning Companies

	Ticker	EV/Operating Profit
Coursera Massive open online courses	COUR	192x
Chegg Online educational support, high school and college	CHGG	7.4x
Stride Virtual public school alternative	LRN	7.1x
New Oriental Education & Technology Private education services in China	EDU	11.4x
Bright Horizons Family Solutions Child care and early education	BFAM	18.6x
Lincoln Education Services Career-oriented education and training	LINC	11.2x

We used each company's operating profit estimate for 2023. We used the Bloomberg consensus of operating profit in 2024 for all companies except for 2U – where we use our own estimate for 2024.

Coursera's extremely high multiple is misleading because the company barely has any operating income. Looking at the remaining five companies, we see that Stride and Chegg are valued similarly at 7.1x and 7.4x expected operating income for 2024.

New Oriental Education & Technology and Lincoln Education Services are valued between 11.2x and 11.4x expected operating results for 2024. Bright Horizons Family Solution is the stock with the highest valuation – 18.6x next year's operating profit.

We believe that 2U should be valued at an EV of between 7.0x and 8.5x operating profit for 2024. The 2024 profit figure is likely to come in around $125 million, with a high-side estimate of $150 million. Except under the most extreme scenario, the value of the business will exceed its total debt.

2U Valuation Table

	2024 Low End Target	2024 High End Target	2025
Operating Profit ($millions)	$125	$150	$175*
Multiple	**Market Cap**		
7.0x	$875	$1,050	$1,225
7.5x	$938	$1,125	$1,312
8.0x	$1,000	$1,200	$1,400
8.5x	$1,063	$1,275	$1,487
Total Debt	**$927**		

**A reasonable estimate for 2025 | ($millions)*

This places the near-term value of 2U between $875 billion and $1.275 billion. As a cross-check, this lines up with reports of a $1 billion bid for the company in June 2022. It has been reported that Byju – a business in India funded by prestigious investors like Sequoia Capital and the Chan Zuckerberg Initiative – was the interested buyer. We can only assume 2U's board of directors turned it down, having viewed the business as worth more than that.

Discussion of 2.25% Convertible Bonds

This newsletter is called *Porter & Co.* ***Distressed*** *Investing*. "Distress" is not usually considered a good thing. Think of a ship sending out a "mayday" signal or a doctor at a hospital yelling "STAT!" Companies don't set out to be distressed. But it happens...

Once a company begins to flounder, investors get nervous – anyone who wants to sell the company's bonds is likely to get paid less than the bond's original $1,000 price.

If the company's problems snowball, the pace of the bond's price decline accelerates. At some point the bonds pick up a "smell." The longer the company's problems continue, the worse the smell gets. Mention the company's name and people groan.

Sometimes the best strategy is to avoid the bond and hold your cash... or put it elsewhere. Sometimes, beneath the bad stench, a savvy investor smells opportunity and discovers value.

That's the case with 2U's bond that we are recommending in this issue – although it's risky, which we will discuss.

2U's 2.25% convertible bond maturing 5/1/25 is a $380 million bond issue that is senior unsecured – meaning that in the event of bankruptcy, bondholders would get paid along with all other unsecured debt, but *after* secured bonds and bank loans are satisfied. As of September 30, there is roughly $397 million in secured debt – backed by company assets.

The company has a total of $527 million in senior unsecured bonds – $380 million for the 2.25% convertible bonds and $147 million for the 4.5% convertible bonds maturing 2/1/30. All of these bonds would get paid *after the bank debt* and before any stockholder would get anything.

If 2U can persuade at least $340 million of the $380 million holders of 2.25% convertible bonds to extend their maturity date until after the bank debt comes due on December 28, 2026, we reckon the odds are 65% to 75% that the bonds will be paid at the full $1,000 at the new maturity date.

To be clear, this is a speculative bond. If the company is not able to convince enough holders of the 2.25% convertible bonds to extend the bond maturity, there's only a slim chance the company could pay the bonds off on time and in full. If the $397 million of bank loans and the $380 million in 2.25% convertible bonds both come due in 2025, it is more likely that the company would be unable to pay both obligations when they are due. **In this circumstance, 2U would likely file for bankruptcy protection.** We give this scenario about a 25% to 35% chance.

As the table above shows, our current valuation range for the business is $875 million to $1.487 billion – as the low end for 2024 and the high end for 2025. There are many factors that determine how much a bond recovers in bankruptcy, so the best we can do is make an educated guess.

Very often, by the time a company reaches the point of bankruptcy, its operating profits have declined – either temporarily or permanently. Plus, the bankruptcy process is expensive – it would cost a company 2U's size around $50 million. Let's pare down our valuation range and assume that in a bankruptcy the business might be worth only $500 million to $800 million. That value would be divided this way:

2U Valuation Scenarios	
Best estimate of business value	**$500 million - $800 million**
Pay off secured debt	**($397 million)**
Value left for unsecured bondholders	**$103 million - $403 million**
Unsecured bondholders:	
2.25% convertible bonds	**$380 million**
4.50% convertible bonds	**$147 million**
Total unsecured debt	**$527 million**
($103 million to $403 million) divided by $527 million equals 19.7% - 76.5%	
Value left for each $1,000 bond	**$197 - $765**

In other words, *if* 2U is unable to get bondholders to extend the maturity of the 2.25% convertible bonds due May 1, 2025, and *if* it is unable to refinance the bank debt on January 31, 2025, it *could* end up filing for bankruptcy. In that case each of the $1,000 bonds would ultimately be worth between $197 and $765.

Let's take a conservative approach and say that in the bankruptcy scenario the bonds would only be worth $300 for each $1,000.

Based on the odds we discussed (many others are possible), we estimate the bonds that are currently trading at $493 are worth between $725 and $855 each.

Pricing and Return Scenarios for 2U Bonds	
65% to 75% chance of $1,000	$650 to $750
25-35% chance of $300	$75 to $105
Weighted average of outcomes $725 to $855	$725 to $855
Current bond price	$493
Total returns (excluding interest)	47% - 74%

Putting It Together

When we take the weighted average of the good outcome (bonds get paid in full, probably in 2027) and the bad outcome (eventual bankruptcy and $300 for each $1,000 of bonds), the bonds at the current price would generate a profit of roughly 47% to 73% over three years. This calculation does not include interest, which would boost the expected return slightly.

At the end of the day, there will be only one result.

Buying 2U's 2.25% convertible bonds today at a price of $493 means about a 70% chance of almost doubling your money, and about a 30% chance of losing half of it. We like these odds and payouts, and we see value in 2U's bonds at the current distressed level. We emphasize that these are speculative bonds with a meaningful chance of gain or loss.

Looking at the Conversion Value

2U's 2.25% bonds are convertible into stock at the price of $28.27. We do not believe this conversion feature has value – or ever will.

Unless exchanged for a different bond, in May 2025 our bonds will receive the *higher* of their $1,000 face value or the value of 35.37 shares of 2U stock. If stock goes above $28.27 per share by May 1, 2025, holders will end up receiving more than $1,000 per bond ($28.27 per share would value the business at over $3 billion). The stock is currently trading at $1.02 per share, and even our highest valuation does not get TWOU anywhere close to $28.27 per share. We view this conversion feature as having no value.

If – against *almost impossibly* long odds – the stock price does go above $28.27 before the bonds mature in May 2025, holders can convert the bonds into stock that will be worth more than the $1,000 face value. A broker will know how to do this. (Before maturity, the market price of the bond is likely to reflect that value – so it can be sold to someone else.)

Risks

Deeply distressed bonds like this one, which is priced at just under half of its face value, are risky investments. The main risks in the case of 2U are:

- *Risk: After losing USC as a partner, additional university partners also leave.*
  Our assessment: We see this risk as limited given 2U's long, 10-to-15-year contracts and diversified portfolio of university programs.
- *Risk: Demand for boot camps and other non-degree programs declines.*
  Our assessment: We think it is more likely to increase over time, given that the demand for training seems like a megatrend.
- *Risk: 2U's bank agreement requires "recurring revenue" of at least $900 million over the prior 12 months.*
  Our assessment: This covenant is measured at the end of each quarter. As long as the company's revenues come close to this number, the banks would likely charge 2U a fee to amend the covenant.

Action to Take
Buy 2U (Nasdaq: TWOU) 2.25% convertible bonds maturing May 1, 2025 (CUSIP# 90214JAB7), up to a price of $550 plus accrued interest. As of January 12, 2024, the accrued interest amounts to $4.69 per $1,000 face amount of bonds.

Because of the high likelihood that this bond will be exchanged for one that matures later than May 1, 2025, we are not using our regular "Bond Box." We have included our estimates of the potential outcomes for this bond in the section entitled "Discussion of 2.25% Convertible Bonds" above.

How to Buy This Bond With a Live Broker

If you are putting in a phone call to your broker, here's a quick breakdown of the steps you'll go through.

1. Tell your broker the number of bonds you'd like to acquire.
2. Provide the name of the borrower, the coupon, and date of maturity.
3. Provide the CUSIP number.

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CUSIP stands for "Committee on Uniform Securities Identification Procedures" and is a unique series of numbers and letters assigned to every traded security. Providing the CUSIP will ensure that you're buying the right security. The CUSIP of the bond we recommend in this issue is 90214JAB7.

Specific Instructions for Buying 2U Inc.'s 5/1/2025 Convertible Bond

Now, the bond we are recommending today is not always tradeable online, so instead you will need to place your trade by phone. We've confirmed that the 2U Inc. 5/1/2025 convertible bond is available through Schwab and at full-service brokerage firms.

> Recall that the bond market is much less popular (and there's much less trading volume) compared to the stock market, so don't be surprised if you are dealing with a broker who knows little about the bond market.
>
> This is part of the reason why, in the bond market, there are fewer market participants and less overall interest, so it's easier to scoop up bargains when opportunities arise.

The instructions for placing an order are usually standard across the brokerage platforms mentioned above.

Here's an example of how the conversation with your broker might go:

Investor: "Hello. I am interested in buying 2U Inc. 5/1/2025 convertible bonds. Can you get me the bond quote so I can decide whether or not I want to buy?"

Broker: "Yes, can you confirm with me the CUSIP?"

Investor: "The CUSIP is 90214JAB7."

Broker: "We don't have these bonds in our inventory. However, we can place open market orders which allows for this bond to be traded and sold through an alternative trading system (ATS). We can get you a quote. How many of these 2U Inc. convertible bonds are you looking to purchase?"

Investor: "I'd like to purchase 25 of the 2U Inc. 5/1/2025 convertible bonds."

Broker: "Okay, I will get you a quote and call you back. Bye."

This is where the first conversation with the broker will come to an end... but within the next 24 to 48 hours of the next trading day, the broker should return your call and will give you the quote (the price) of the bond. This call is when you will place and confirm your order.

After your initial call to receive the quote, the broker will call you back in most cases and after he confirms he's speaking to the correct person, he can go ahead and place your order.

Here's how the second call might go:

Broker: "Hello, this is John Doe, the fixed-income specialist you spoke to earlier. I am calling to give you a quote for the 25 2U Inc. 5/1/2025 convertible bond bonds you inquired about earlier today. The price for the size of your request to buy 25 bonds is $49.30 plus accrued interest. Would you like to go ahead and place the trade?"

> Note: The $49.30 price he quoted is really $493 for the cost of each bond. When quoting bonds, brokers will most likely drop the last zero, so $49.30 becomes $493. Now, if the investor decides to purchase 25 bonds, his total will be $12,875 ($493 × 25 =$12,325) plus $117.25 for accrued interest ($4.69 x 25 = $117.25) and any commission or service fee.

Investor: "Yes. The total comes out to $12,442.35 plus the service fee. Is that correct?"

Broker: "Yes, it is correct. I will go ahead and make the transaction. You will get an email confirmation over the next 24 hours. Have a great day!"

As always, if you have questions, please call Lance, your personal Porter & Co. Concierge at (888) 610-8895, or internationally at +1 (443) 815-4447. We do not endorse any specific brokerage and are offering this guide for informational purposes only.

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P.S. If you'd like to learn more about the Porter & Co. team – all of whom are real humans, and many of whom have X accounts – you can get acquainted with us **here**.

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