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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the second-quarter 2013 American Public Education, Inc. earnings conference call. My name is Shaquanna and I will be your coordinator for today. At this time, all participants are in a listen-only mode. We will facilitate a question-and-answer session towards the end of this conference. (Operator Instructions).

I would now like to turn the presentation over to your host for today's call, Mr. Chris Symanoskie, Vice President of Investor Relations. Please proceed, sir.

Chris Symanoskie - *American Public Education, Inc. - Associate VP of IR*

Thank you, operator. Good morning, and welcome to American Public Education's conference call to discuss financial and operating results for the quarter ended June 30, 2013. Presentation materials for today's call are available on the Webcast section of our Investor Relations website, and are included as an exhibit to our current Report on Form 8-K filed earlier today.

Please note that statements made in this conference call regarding American Public Education or its subsidiaries that are not historical facts are forward-looking statements, based on current expectations, assumptions, estimates and projections about American Public Education and the industry. These forward-looking statements are subject to risks and uncertainties that could cause actual future events or results to differ materially from such statements. Forward-looking statements can be identified by words such as anticipate, believe, could, estimate, expect, intend, may, should, will, and would. These forward-looking statements include, without limitation, statements about the third-quarter and full-year 2013, as well as other statements regarding expected future growth.

Actual results could differ materially from those expressed or implied by these forward-looking statements as a result of various factors, including the risk factors described in the Risk Factors section and elsewhere in the Company's Annual Report on Form 10-K filed with the SEC; the Company's Quarterly Reports on Form 10-Q filed with the SEC; and the Company's other SEC filings. The Company undertakes no obligation to update publicly any forward-looking statements for any reason, even if new information becomes available or other events occur in the future.



This morning, it's my pleasure to introduce Dr. Wallace Boston, our President and CEO; and Harry Wilkins, our Executive Vice President and Chief Financial Officer. Now at this time, I'll turn the call over to Dr. Boston.

Wallace Boston - *American Public Education, Inc. - President and CEO*

Thank you, Chris. Good morning, everyone. I will begin today's call with an overview of our second-quarter operating results, and a brief discussion about our approach to improving our quality mix of new students. Then Harry Wilkins, our Chief Financial Officer, will discuss our financial results in more detail, and provide perspective on our outlook for the third quarter of 2013.

For the three months ended June 30, 2013, net course registrations increased 7% compared to the prior year period, and net course registrations by new students declined 9% year-over-year. We believe that net course registrations were negatively impacted in part by the temporary suspension of new enrollments in the Department of Defense Voluntary Education Tuition Assistance Programs that occurred in March of 2013, and primarily in April of 2013.

In the second quarter of 2013, excluding net course registrations by students using TA, overall net course registrations would have increased 14% year-over-year, and net course registrations by new students would have increased 1% year-over-year. Moreover, net course registrations by new students using federal student aid increased approximately 3% year-over-year, compared to a decline of 5.6% in the first quarter of 2013. While we continue to address several challenges, we see this increase as an early sign that certain aspects of our overall approach are producing positive results.

For example, we continue to adjust our marketing mix away from traditional media in favor of interactive media and a more targeted relationship-oriented approach to improve the qualifications of our incoming students. On average, our FSA completion rates continue to improve -- a clear indication that we are positively impacting student quality overall. We believe these adjustments, coupled with new programs and new strategic partnerships, will ultimately lead to an expanding overall student population, with greater college-readiness and higher overall success rates.

In fact, today, we are conducting our earnings call from Orlando, Florida, where we are attending New Horizons Global Franchise Conference. In 2012, we announced plans to expand our international student population through a new investment in and relationship with New Horizons Worldwide, Inc., a global independent IT training company. At this annual conference, we are presenting, networking, and developing relationships with New Horizons franchisees from around the world. The next few weeks, we plan to launch a new program, a beta test with one of the largest franchisees, to offer their students and corporate customers access to APU's degree programs.

During the second quarter of 2013, we further expanded our corporate and other relationships through new agreements and relationships with the Software and Information Industry Association, a leading global association representing approximately 700 member companies, and thousands of professionals in the software and digital content industries; the US Hispanic Chamber of Commerce; the Association of Latino Professionals in Finance and Accounting; and the American Society of Transportation and Logistics, as well as with several public safety organizations and community colleges.

As we continue to cultivate these opportunities, we seek to continually optimize our operations and improve student success through innovation. For example, our ePress online library solution initiative has been tremendously successful at lowering textbook and course material costs, while at the same time supporting student success and satisfaction. In July, we launched an updated version of Sakai that offers multiple device capability, including mobile.

In addition, we believe our extensive efforts to reduce Title IV fraud and abuse have had positive effects. We believe this reduction in fraud abuse had also led to improvements in the classroom experience and completion rates, as well as the lower bad debt expense as a percent of revenue. While these developments and innovations benefit students in the efficiency of our online delivery of services, they also lead to growing recognition. Once again, American Military University was ranked at the top of the Military Times Magazine's Top 50 Most Popular Schools in its June 2013 edition. Moreover, the increased recognition for academic quality and affordability helps build greater reputational capital.



Moving on to slide number 4, adding to our momentum in this regard is a strong ongoing relationship with the Lumina Foundation for Education, and our adoption of Degree Qualifications Profile or DQP. The DQP is a transformative learning framework with specific benchmark learning outcomes that clearly define goals for quality and student achievement. Having adopted the DQP learning outcomes framework as our institutional learning outcomes, we added digital information literacy as an additional area of learning, which, we believe, is a differentiating feature of our institutional mission, and that it will result in our students being better prepared by aligning their learning outcomes with higher education and industry standards.

As of July 2013, APUS has mapped all degree programs to the Lumina Foundation's Degree Qualifications Profile. As a result of our successful implementation, the National Institute for Learning Outcomes Assessment, NILOA, an association dedicated to establishing best practices of student assessment plans to publish our DQP implementation as a case study. APUS has also been invited to participate in the John Gardner Institute for Excellence Gateways to Completion, or G2C, research initiative -- a comprehensive institutional course improvement process for courses challenged by low national completion rates. Our Provost, Dr. Karen Powell, has been invited to be a member of the G2C Executive Advisory Committee.

As a leader in research and the implementation of innovative distance-learning technologies, APUS has partnered with the University of Professional and Continuing Education Association, UPCEA, the University of Illinois, Springfield, and several other member institutions, to examine the potential of a massive -- massively open online courses for MOOCs, and how MOOCs could integrate into traditional degree completion programs. This pilot program, funded through an American Council and Education, or ACE, grant from the Bill and Melinda Gates Foundation, will help determine how students succeed after having received credit for a MOOC.

JSTOR, a leading archive of scholarly research material, reported that APUS was its second-most-active user. A few years ago, APUS was the first for-profit university to gain entrance to this leading international archive of scholarly articles. APUS student research activities continue to expand, and are assisted by the specialized tools, course materials, and award-winning library services provided by APUS.

In expanding the foundation for our international outreach, we must also meaningfully engage and support the international academic community. As such, we've been invited to be a member of the International Council for Open and Distance Education, ICDE, a leading global organization and a consultative partner with UNESCO. In addition, Dr. Fred Stielow, our Vice President and Dean of Libraries, was appointed to the American Library Association position as Library Representative on the US National Commission for UNESCO. This federal advisory committee supports worldwide humanitarian development by delivering expert advice on issues of education, science, communications and culture.

Our academic quality initiative has also built a strong foundation from which we can develop new programs. With the recent addition of five new programs -- an MA and BA in entrepreneurship, a BA in mathematics, a BS in engineering, and a BA in sports and health sciences -- APUS now offers more than 90 degree programs to over 100,000 students. We believe these programs and several other programs currently in development properly address areas of higher long-term demand in an otherwise challenging overall higher education market.

Moving on to slide number 5, while our leading academic provider position within the military community continues, evolving budgetary and administrative practices within the DoD's Education Program create additional challenges. For example, several services recently issued guidance to their Education Service Officers, or ESOs, to approve applications for tuition assistance no more than 30 days in advance of a class start. A shortened enrollment period makes it more difficult for us to predict future enrollment by active-duty military. Moreover, as the DoD's fiscal year-end approaches on September 30, we believe that certain branches of the military may be reaching their budgeted amounts for tuition assistance, which, in turn, may mean that some applications for tuition assistance will not be approved until the start of the new fiscal year in October.

Although we believe many of these matters are temporary, we operate under the assumption that the US military will be confronted with sequestration and other funding-related challenges for the foreseeable future. We are encouraged by Congressional support for the Tuition Assistance Program, and by the availability of additional funding sources for active-duty military, including veteran's benefits and federal student aid. There are no certain assurances, however, that the Voluntary Education Programs at home or abroad will not be changed in a manner that could have an adverse impact on our operations.

We intend to continue with our successful relationship-oriented approach to serving military members and their families, seek new approaches to engaging key influencers, and add new degree programs that meet the career needs of military members, such as nursing and engineering, to

name a few. Our efficient business model and long-term goal of serving a growing number of civilian students in today's challenging market rests in large part on finding the right quality mix of students, students with higher overall persistence and success rates.

We believe that the adjustments we have made to our outreach efforts in favor of interactive media and a more targeted relationship-oriented approach have produced positive results so far, including an improvement in our first course completion rates. Our task is now to enhance these efforts in a way that increases the persistence rates, and identifies and enhances the preparedness of civilian students. We believe this is best accomplished through an even greater focus on relationships and referrals; programmatic adjustments to high demand fields of study, such as healthcare and engineering; enhancing the first-year experience for transfer students; and through diversifying into new segments, including through international students and school-as-a-service.

We will also continue to innovate and create operational efficiencies. Our PAD system, automated credit transfer evaluation system, and ePress initiatives are important examples of how we create efficiencies and improve student services. As we previously discussed, we are bringing our financial aid processing in-house to improve student services and generate additional cost savings. The initial feedback from students regarding the financial aid application process under the new system has been positive.

We are hearing that students find My Aid Portal, the new user interface, to be informative and intuitive. However, a third-party vendor had issues with converting data from our proprietary PAD system, and transmitting information to the Department of Education, resulting initially in disbursement delays in July, some registration delays, and perhaps a loss of net course registrations. This caused dissatisfaction from students seeking disbursements, and was reflected in social media and elsewhere.

We have been working with our vendor to resolve the various issues causing these difficulties. At this time, we cannot estimate the impact this may have on student satisfaction and on net course registrations. And while we anticipate these issues being resolved, there are no assurances as to when they will be completely resolved. Once resolved, we expect to have a more cost-effective scalable system with significantly improved student service capabilities.

Our outlook for the third quarter of 2013 reflects our caution and the continued uncertainty with regards to the military's Voluntary Education Program, the estimates of the potential impact from delays in financial aid processing, and to the impact of our marketing shift in a difficult overall environment. That said, we believe we are making the right choices for the future, and for the benefit of our students and alumni.

Going forward, we intend to further refine our marketing mix of media and outreach spending. We also plan to continue our partnership initiatives and efforts at international outreach. We believe that the most effective and affordable approach to achieve our goals is to build partnerships, focus on high-demand fields, diversified tuition funding sources, and address opportunities in new segments. At the same time, we will continue to work to innovate in order to create operational efficiencies and improve student services. Most importantly, we will continue to focus on academic quality and positive student outcomes, as we have successfully done in the past. We believe our focus on academic quality, diversification of tuition funding sources, and a proven quality mix of our student population, combined with a commitment to affordability and innovation, is the winning strategy.

Now I'll turn the call over to our CFO, Harry Wilkins, for a review of our financial results in more detail. Harry?

Harry Wilkins - *American Public Education, Inc. - EVP and CFO*

Thanks, Wally. Turning to slide 6, our second quarter of 2013 financial highlights, American Public Education's second-quarter 2013 financial results include a 9% increase in revenues to \$80.9 million compared to \$74.5 million in the prior year. The revenue increase was primarily driven by growth in net course registrations, as well as by increased revenue associated with the implementation of a technology fee for courses beginning after September 1, 2012.

Operating income for the second quarter 2013 increased 15% to approximately \$17.2 million compared to \$15 million in the same period of 2012. Instructional costs and services decreased to 33.6% of revenue in the second quarter of 2013 compared to 35.2% in the prior-year period. This decrease was primarily related to cost savings from our ePress initiatives, online library initiatives, greater use of eBooks, and improved utilization



of full-time faculty. Selling and promotional expenses as a percent of revenue increased slightly to 19.8% of revenue compared to 19.5% in the prior-year period. This increase was primarily related to higher costs associated with online advertising and increased staff focused on strategic relationships.

General and administrative expenses decreased as a percentage of revenue to 21.3% from 21.6% in the prior-year period, due to a headcount growing slower than revenue and a slight improvement in our bad debt expense. Bad debt expense as a percentage of revenue was approximately 3.9% in the first quarter -- I'm sorry, in the second quarter of 2013, compared to 5.1% of revenue in the second quarter of 2012 -- a clear indication that we are attracting fewer fraud and abuse students. Moreover, our overall margin improvement has resulted from innovations in areas that, first and foremost, improved student services, student success, and student satisfaction.

In the second-quarter 2013, net income was approximately \$10.8 million or \$0.60 per diluted share, ahead of our guidance. This represents a 17% year-over-year increase in net income, with an 18% increase in diluted earnings per share. Please also keep in mind that the second quarter earnings per share included approximately \$0.02 per diluted share of legal and financial due diligence expenses incurred in connection with the Company's review of potential transactions. Our cash balance as of June 30, 2013 was approximately \$128 million. We have no long-term debt. During the quarter, we repurchased approximately 62,000 shares, and there remains approximately \$16 million of authorized availability under our authorized stock repurchase programs as of June 30, 2013.

As Wally mentioned, in the beginning of July, we brought our financial aid processing in-house, and we are experiencing additional unexpected delays in processing. We believe these delays are the result of various conversion issues with the new software that result in some student records being rejected by the Department of Education. Our financial aid team and our software vendor are working quickly to analyze code and deploy fixes to correct these issues as we identify them. However, this is affecting financial aid registrations in the third quarter of 2013.

Currently, we cannot estimate the impact this may have on course registration, which is in part because we cannot estimate when these issues will be fully resolved, and we cannot estimate the number of students who will decide not to enroll with APUS as a result. The initiative to automate and bring financial aid processing in-house is aimed at improving our financial aid services, and bringing approximately \$120,000 per month more of future cost savings, once this matter is resolved. Moreover, the initial feedback from students not impacted by disbursement delays has been quite positive. The new financial aid portal is easy to use and it is informative.

Turning to slide 7, third-quarter outlook for 2013, APEI believes that net course registrations in the third quarter will be adversely impacted by delays in processing certain FSA applications, and in the transitioning of our marketing mix away from traditional mass media. We also believe that course registrations could be adversely impacted by evolving budgetary and administrative practices within the Department of Defense Voluntary Education Program, and other possible factors.

As a result of these events and other factors, American Public Education expects growth of net course registrations by new students in the third quarter of 2013 to decline between negative 15% and negative 11% year-over-year, and net course registrations to be approximately flat compared to the prior year. The Company anticipates third-quarter 2013 revenue growth of between 0% and 4% compared to the prior year. Earnings per share are expected to be between \$0.52 and \$0.56 per diluted share.

In summary, we are pleased with our second-quarter results. Especially noteworthy is our improving quality mix of students and operating margin performance. We enjoyed continued cost savings from our ePress initiative; bad debt expense as a percentage of revenue continued to improve, owing in part, we believe, to measures put in place last year to reduce financial aid fraud and abuse. Moreover, we accomplished these successes while dealing with a temporary suspension of tuition assistance in April, and making continuing -- and continuing to make programmatic and marketing-related adjustments to improve our overall effectiveness.

In light of these challenges, we believe that we are making the right choice, and the right choices for long-term success. Our strategy includes increasing our presence in the military and civilian communities through even greater focus on relationships and referrals, and by focusing on high-demand skills to further help drive growth in a difficult overall market. In this challenging economy and regulatory environment, diversification of revenue away from government sources and new lines of business are an important part of our long-term strategy to create value and stability.



We plan to expand our efforts to develop relationships with corporations, associations, community colleges, and government agencies, an approach that we think will be highly effective.

Now at this time, we are happy to answer questions from the audience. Operator, can you please open the line for questions?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Jerry Herman, Stifel.

Jerry Herman - *Stifel Nicolaus - Analyst*

I appreciate you guys giving some color on the delay and disbursements in the financial processing issue. I'm hoping you can fill in. I'm not sure I quite understand how the third party came into play and was a factor in that impact?

Wallace Boston - *American Public Education, Inc. - President and CEO*

Sure, Jerry. We used to use Global, which is an outsourcing company. And we decided, for a number of reasons, to bring it in-house. And we're using a software package, which comes from a company called Regent. And so, using their package, it's required for all the calculations and how you actually package the materials of the students. That implementation, particularly the conversion of people from one system to a new system, coinciding with the switch of the fiscal year, caused some -- there were some file issues that caused delays.

I think, Harry, if you want to add some more color to that.

Harry Wilkins - *American Public Education, Inc. - EVP and CFO*

Yes. The front-end of the process, the actual packaging of the students has gone very smoothly under the new system. This is the system -- the software that we use as our virtual financial aid office when students apply for financial aid.

The part of the system that was difficult to test was the interaction with the Department of Ed, through their disbursement files -- their COD system, as they call it -- you can't test -- the Department doesn't allow you to test files in their system. You have to use actual live data. When we sent the first files over to them, many of them were rejected. And apparently, it's just a conversion issue with the new software abstracting data from our PAD systems, and putting it in a way that the Department of Education can get the information they need and disburse the funds. So that's the very last thing in the process.

So -- and the other thing is that, other companies delay their disbursements to students. They use multiple disbursements. We have not done that. We've chosen to continue to have one disbursement for students when they first start and that doesn't delay the disbursements for them. So the students that are delayed with us, if they had gone somewhere else, they wouldn't be getting the money yet anyway. So this is something that we're working on to correct. It's causing some disruption for certain amount -- part of our student population. And I think until we get it straight, they probably will not be able to enroll in August and September classes. So, that's reflected in our guidance for the third quarter.

Jerry Herman - *Stifel Nicolaus - Analyst*

Is there some reject rate associated with the Department saying no? I.e., the percentage of apps that were rejected?



Harry Wilkins - American Public Education, Inc. - EVP and CFO

Actually, Jerry, most of the ones that were rejected were the ones that converted over. And so applying reject rates to file conversions where people had transitions -- for example, they had held at -- that transitioned over the fiscal year, and had to have awards. And that data required data coming over from the global system correctly. We believe that most of the new students processed are not going to have these similar issues, because they are not bringing over a file from the old system. And it's primarily the conversions and the dissatisfaction of people whose file converted over.

Jerry Herman - Stifel Nicolaus - Analyst

Okay. And a high-level question for you, Wally, I guess, in particular. There's been a lot of, let's call it, price competitiveness or discounting scholarship in the sector. I mean, how do you view your value proposition, which has always been based on being priced so much lower than the competition? Do you, in any way, sense some erosion of that differentiation?

Wallace Boston - American Public Education, Inc. - President and CEO

I don't know that I'd say an erosion. I think the market, the online market, is much more competitive, with many public institutions now offering online degrees that they didn't a year ago. But if you look at our second-quarter results, when you take away the TA because of the suspension, we actually had some decent growth. And whereas comps are people still having negative numbers. The third quarter, we're showing negative growth, but we believe a big piece of that is due to our FSA situation.

So I think the affordability still resonates. When we benchmark ourselves, we're about 20% below the national in-state average for tuition. So, while in certain markets we may not be that low, nonetheless we think that our affordability still holds up well to everyone, even the for-profits that are discounting. The only thing that I might say is that perhaps, psychologically, people feel better by hearing that they're getting a \$20,000 scholarship; but if they actually compare the numbers, we're still more affordable.

Harry Wilkins - American Public Education, Inc. - EVP and CFO

Yes. And the other thing is, Jerry, while some of our competition is trying to do some things to get down to our price point, we can hang at these prices for a long time. We haven't increased our tuition since 2001. So we can be very competitive for a long time at lower tuition prices. We'll see how that strategy in the long run bears out for our competition with higher cost structure than we have.

Jerry Herman - Stifel Nicolaus - Analyst

Great, guys. I'll circle back.

Operator

Adrienne Colby, Deutsche Bank.

Adrienne Colby - Deutsche Bank - Analyst

Thanks for taking my question. I was wondering if you could break out the impacts of the tuition assistance issues and financial aid on the guidance you've given for new course registrations? Just to help break that out a little bit.



Harry Wilkins - American Public Education, Inc. - EVP and CFO

I don't think we have an idea. We try to aggregate our projections based on enrollments without looking at the type of payer. And right now, we think these projections are as accurate as we can give. And there are two things that are influencing them downward. And one is some of the bases are running out of tuition assistance money. But even more so, with our FSA situation, we just think it's causing some students to find -- to go somewhere else where they're comfortable that they can get their disbursement quicker.

Wallace Boston - American Public Education, Inc. - President and CEO

Well, yes, I mean, we have this -- we run into this problem every year in the third quarter. The end of the government's fiscal year is September 30. And as different bases or different branches of the services run out of TA money for this year, they may be encouraging students to wait until October to register. And we don't really have any way of knowing that. So it makes it difficult for us to give guidance in the third quarter. And then, of course, with this FSA situation, we -- we're not sure -- we have some students who are upset with us because a portion of them didn't get the funds as soon as they would have liked dispersed to them. And how many of them will delay registrations for future periods or just get so upset with us that they leave, we're not really sure at this point.

So, we're always cautious with our guidance. I think that's reflected in the guidance we've given. But we really can't be much more specific at this time about it.

Adrienne Colby - Deutsche Bank - Analyst

Okay. I guess I'm also just trying to understand too why you're expecting to see flat new course registrations? I know you've, in the past, you've had negative new course registrations from new students, but you've been able to maintain positive growth, at least in your total course registrations. And I think a lot of that was due to persistence. So I'm wondering if you're seeing some changes there?

Wallace Boston - American Public Education, Inc. - President and CEO

Again, the situation with TA and the situation with these FSA's, that would affect both new and continuing students. So, I just think that our guidance reflects that.

Harry Wilkins - American Public Education, Inc. - EVP and CFO

Yes, I think also a certain portion of our total registration growth is dependent on new students. So if we're showing a decrease higher than we normally do in new students, that's going to impact the overall total.

Adrienne Colby - Deutsche Bank - Analyst

Okay. Do you still anticipate being able to stay at or below 20% of marketing as a percent of revenue for the full year?

Harry Wilkins - American Public Education, Inc. - EVP and CFO

That's our goal.

Adrienne Colby - Deutsche Bank - Analyst

Great. Thank you.



Operator

Corey Greendale, First Analysis.

Corey Greendale - *First Analysis Securities - Analyst*

First question -- maybe I'll try to play a different angle on what Adrienne was asking about. Can you give us a sense what the new student registration trends were in Q2, specifically within Title IV and TA?

Harry Wilkins - *American Public Education, Inc. - EVP and CFO*

Yes, the -- you said new or total?

Corey Greendale - *First Analysis Securities - Analyst*

New.

Harry Wilkins - *American Public Education, Inc. - EVP and CFO*

Good. New -- TA students were up about 3%. And TA was down about 2% to 3% -- I mean FSA. FSA -- Title IV was up about 3%. (multiple speakers)

Corey Greendale - *First Analysis Securities - Analyst*

Okay, sorry. Title IV up 2%, TA down 2% to 3%?

Harry Wilkins - *American Public Education, Inc. - EVP and CFO*

Yes.

Corey Greendale - *First Analysis Securities - Analyst*

Okay. And then (multiple speakers) --

Harry Wilkins - *American Public Education, Inc. - EVP and CFO*

Okay, I'm sorry, because of April, new student -- we didn't have any new student -- military students in April because of the TA situation. So, tuition assistance students, new tuition assistance students in the second quarter of 2003 were down 23%.

Corey Greendale - *First Analysis Securities - Analyst*

23%? But with effectively a zero in one of the three months?



Harry Wilkins - American Public Education, Inc. - EVP and CFO

Yes. That's correct.

Corey Greendale - First Analysis Securities - Analyst

Got it. Okay. And then kind of digging into some of the -- I understand kind of what's going on. I'm hoping to get just a little bit more color on the reasons for it. So with the FSA's processing issues -- so you've had two of the Q3 monthly starts so far. Can you just give us a little more on why the issue hasn't been resolved in the August start when it came up in the July start?

Wallace Boston - American Public Education, Inc. - President and CEO

Actually, the August disbursements aren't scheduled yet. While Harry said we do one disbursement and it's fairly early, it's not scheduled until the middle of the month. So we've only had one disbursement scheduled run in July, and we had that run initially a little late -- later than we planned. But most of those disbursements have been made. It's just there are a couple of different categories related to file conversion that we still need to make disbursements on.

Harry Wilkins - American Public Education, Inc. - EVP and CFO

And as we discussed on our last call, in order to implement this new system, we had to actually shut down financial processing for a week. And our registrations are fairly steady from one week to the next. When we shut down for a week, you don't know when -- how much of a deferral that actually costs.

Corey Greendale - First Analysis Securities - Analyst

Okay. So does all that suggest that it was more of a July start issue and that it should be somewhat resolved for the August start?

Wallace Boston - American Public Education, Inc. - President and CEO

That's -- well, we're hoping on that but we certainly can't predict it, Corey, so. (multiple speakers)

Harry Wilkins - American Public Education, Inc. - EVP and CFO

Well, then you have the shutdown in July compounding the -- actually, it was late June, we shut down the system and couldn't process anybody. And then you compound that with delaying disbursements for a portion of the July population, so you're not sure -- we're not sure how much of an impact that actually is going to have in August and September at this point.

Corey Greendale - First Analysis Securities - Analyst

Okay. And then on the TA side, so there was the temporary suspension. It doesn't sound like you've seen students come kind of rushing back. So why is it that the overall TA pool would be running out of money, given that there was a suspension for a couple of months?

Harry Wilkins - American Public Education, Inc. - EVP and CFO

Well, the TA was actually running ahead of budget, in terms of expenditures, before they suspended it. And then when Congress restored it with their amendment, they restored it to the original budget levels. So, while it was suspended for a full month, and a few of the branches might have

delayed for a couple of weeks bringing it back, we did have a situation -- I think it was in the month of June, for example, the Marine Corps decided to take their remaining funds and allocate it by quarter. And so for the month of June, they suspended it again.

Now, it didn't make any headlines and it's not really material to us, but it was -- each of the services did something different with their money, and they were actually spending ahead of budget, which is typical of most years -- they spend ahead of budget. But in most years, they found the money to cover it somewhere in the DoD budget. But we're -- we don't feel comfortable predicting that they'll find the money to cover it this year, given the sequester issues.

Corey Greendale - *First Analysis Securities - Analyst*

Okay, that's helpful. And then the last one for me on the initiative to kind of shape your incoming classes of people more likely to succeed. Is that primarily a change in marketing mix and the things you've done to screen out stipend chasers? Or are there other things you're doing to screen people out once they begin enrollment process?

Wallace Boston - *American Public Education, Inc. - President and CEO*

Well, we put a number of things in there to chase out the stipend chasers. But at the same time, the combination -- what we were doing before with our traditional media was focusing that on getting the biggest bang for the buck in the major population areas. And so we drilled down much more strategically to match up demographics with what the profile of the most-likely-to-succeed college student will be. And that's how we're implying a combination of interactive media with some traditional media and targeted markets.

Corey Greendale - *First Analysis Securities - Analyst*

Great. Thank you.

Operator

Jeff Silber, BMO Capital Markets.

Jeff Silber - *BMO Capital Markets - Analyst*

Sorry to go back to this financial aid disbursement issue. But you had mentioned that new students were not the ones that were hurt. It was only continuing students. So if I look at the total amount of students that applied for financial aid from the federal government, roughly what percentage were rejected in July?

Wallace Boston - *American Public Education, Inc. - President and CEO*

Well, actually what -- the bigger problems were in file conversions. But initially, we had a problem because the Department of Education changed its loan origination fee. And just about everybody who was using automated software didn't get the right loan origination fee, so all those packages. So we even have new students who initially were impacted until we could put the correct loan origination fees in.

Harry Wilkins - *American Public Education, Inc. - EVP and CFO*

Yes, there were a couple of different issues. The Department did raise their loan origination fee from 1% to 1.05% on July 1, and didn't really get the word out. And a number of schools were impacted by that. So when you submit their loan disbursement file with the wrong origination fee,

they reject that. So by the time we got the rejection, which was two weeks into the quarter, then go back and fix it, that does impact a number of students. Then by the time you get the aid, they may not even be eligible for it, based on their academic performance.

But the bottom line is, we're still not sure what the total impact will be on the third quarter. Remember, the third quarter includes September enrollment. So we're not sure what the impact on enrollment will be. And we're not going to give out any percentages until we get the situation completely fixed.

Jeff Silber - *BMO Capital Markets - Analyst*

Okay. All right. Let me go back to second-quarter results then. The revenues and your total net course registrations came in a little bit light compared to your guidance. Where was the weakness compared to what you had expected?

Wallace Boston - *American Public Education, Inc. - President and CEO*

I think it was in TA primarily. We hoped that most of the April losses would come back at a quicker pace than they ultimately did. And as I mentioned, I think on Corey's question, the Marine Corps blocked out June, because they said they ran out of funds. Now the Marine Corps is only a single digit percentage of our overall military population, but nonetheless, it did not come back as fast as we had originally projected.

Jeff Silber - *BMO Capital Markets - Analyst*

Okay, great. I'll get back in the queue, thanks.

Operator

Jeff Volshteyn, JPMorgan.

Jeff Volshteyn - *JPMorgan - Analyst*

Thank you for taking my question. I wanted to ask about costs and expense line items. What is the target level for full-time faculty? And how much efficiencies do you think you still have in that line?

Wallace Boston - *American Public Education, Inc. - President and CEO*

Well, a lot of that -- the efficiencies we're getting in that line, let's talk about the book initiative to begin with. Two years ago -- because we're the only company I know that actually pays for textbooks for undergraduate students. So, other companies can't get savings there. We were paying two years ago \$62 per course for books for students. We've gotten that down to about \$41 per course per student. And we expect to get that even lower by additional initiatives. And we're finding that the students are adjusting just as well. They actually -- a lot of the eBooks they like just as well if not better. So we're actually seeing improved services for our students with the cost savings there.

Then, the other thing that we try to do is manage our full-time faculty. And that's a continuing issue -- how many courses you give to the full-time faculty versus the adjuncts. The adjuncts are paid on a per-student basis, so that that cost is totally variable. The full-time faculty is more of a fixed cost, and to the extent we can manage that, we can get some cost savings.

But this year, we've been gradually adding full-time faculty. This year, we decided to keep it at the same numbers as last year, primarily, because we weren't sure as to how Obamacare might impact our costs, since full-time faculty are eligible for full benefits, including healthcare.

Jeff Volshteyn - JPMorgan - Analyst

Okay, that makes sense. And on bad debt expense, how should we think about it going forward third-quarter and perhaps fourth-quarter?

Harry Wilkins - American Public Education, Inc. - EVP and CFO

Well, we've always said that if we were -- 90% translates to, we have about 5% bad debt. So as our percentage of financial aid students increases, you would expect bad debt to go up a little bit. We really got it down this year by implementing a lot of procedures to keep abuse students out of the system. So, that's been effective. But I think somewhere between 4% and 5% is where bad debt is going to end up for us for the next year or so.

Jeff Volshteyn - JPMorgan - Analyst

And last question for me. Any updates on the more formalized Walmart relationship?

Wallace Boston - American Public Education, Inc. - President and CEO

You know, no updates. We continue to have students that come to us from Walmart, I believe on a minor basis. They are actually updating their internal website. So, hopefully, that internal website will generate some more students. But as far as what they do with their benefit programs, we've just left that up to them to make that announcement if and when it happens.

Jeff Volshteyn - JPMorgan - Analyst

Thank you very much.

Operator

Peter Appert, Piper Jaffray.

Peter Appert - Piper Jaffray & Co. - Analyst

So Harry or Wally, can you give us any more color in terms of the economics of the New Horizon deal in terms of price points and expectations around number of students you might be anticipating over the next couple of quarters?

Wallace Boston - American Public Education, Inc. - President and CEO

Well, actually, no, only because, really, for a number of reasons, this has been -- we decided we weren't going to send a whole team of people to all 70 countries where they have franchises. And it was strongly suggested that, really, the way to make this work would be to attend this annual meeting that we're doing here in Orlando.

So I think in the good news, we did mention that we've got a beta going with one of their largest franchisees that will kick off in the next couple of weeks. But last night, there was an event that we were able to meet a number of franchisees that we had not had any discussions with previously. So we think that we'll come out of this with a positive approach. We think we'll come out of this with more betas, and eventually, hopefully, a program that works for all of the locations. But it's really too soon to tell.



Harry Wilkins - *American Public Education, Inc. - EVP and CFO*

Yes. And we are currently exploring -- we don't have a lot of history of dealing with regulatory environment in foreign countries. We have a tough regulatory environment in the US. We are very familiar with dealing with that. So that's where we are now. There's a lot of interest we're finding with these foreign franchises of New Horizons in trying to help us get our market -- get our product to the market in foreign countries.

What we're trying to do is determine which countries would be best for us from a competitive standpoint for our product, and then also which countries have a more favorable regulatory environment. And we're still in the infancy stages of rolling that out. But when we do decide, I think we can make a push fairly quickly. We have a very good partner in New Horizons. They are very experienced at marketing educational products in foreign countries. They have locations in 70 countries now. And they sell to working adults, so that's our target market. We're thinking this is going to be a really good long-term strategy for us, but we probably won't see many results until the fourth quarter into the first and second quarter of next year.

Peter Appert - *Piper Jaffray & Co. - Analyst*

Is it a revenue share kind of deal?

Wallace Boston - *American Public Education, Inc. - President and CEO*

No. No. (multiple speakers) What we've done is we've evaluated their programs for learning, and several other programs that have heaviness of academic learning that can transfer, for example, into our information technology, either certificates or degrees, they'll get credit. So it's sort of a win-win. It helps them promote their programs, but it gives us a good source of students who are interested in taking their learning to the next step, which is to earn a college certificate or degree.

Harry Wilkins - *American Public Education, Inc. - EVP and CFO*

And there's various models we're experimenting with. Because -- and some of them are dependent on the regulatory environment of a specific country. So there, obviously, will be some type of way to make sure both companies benefit. But we're exploring which models work right now.

Peter Appert - *Piper Jaffray & Co. - Analyst*

Okay. And then, Harry, is your expectation that you have sufficient visibility around the problem with the financial aid challenges that this will be resolved in the third-quarter? Or do you think it lingers beyond that?

Harry Wilkins - *American Public Education, Inc. - EVP and CFO*

At this point, we're still in the -- we're still fighting the good fight. And I'm confident it will be resolved. The exact date of when it will resolve, I don't know. But each day is a step forward. And we're fixing things on a daily basis. So, that's what we're going to say at this point. We're making progress but we're not there yet.

Peter Appert - *Piper Jaffray & Co. - Analyst*

Got it, thank you.

Operator

(Operator Instructions). Timo Connor, William Blair.

Timo Connor - *William Blair & Company - Analyst*

I wanted to make sure on the timing of the course ticker issue, I think you're through the worst of this. You put some pretty aggressive filters in place on the second quarter last year. Is it fair to say that going forward, you're going to be comping against quarters where you're filtering out the kind of right level of students?

Wallace Boston - *American Public Education, Inc. - President and CEO*

Yes. (multiple speakers)

Harry Wilkins - *American Public Education, Inc. - EVP and CFO*

Yes, I think that's very fair.

Timo Connor - *William Blair & Company - Analyst*

Okay. And then whether it's MOOCs, direct assessment models, a number of the new, I guess, delivery mechanisms that are out there, where are you guys focusing your efforts? And where do you see the most opportunity?

Wallace Boston - *American Public Education, Inc. - President and CEO*

Sure. Well, we've always done direct assessment and competency-based learning evaluation, so that's nothing new to us. It's not a big piece of what we do. But we continue to look on ways to expand that, particularly as it becomes more acceptable, including approval programs by the US Department of Education.

As far as MOOCs go, our thoughts about MOOCs are simply that they are probably much better for use for marketing than they are for effectively teaching people. You know, we've capped our class size at 25 for year. And in fact, when we have math classes, we cap the class size at 16. And we found that we generate better learning outcomes.

So I think the MOOCs, the reason they put a whole bunch of people in the class is because they are not charging them for it. So it's really a self-motivated, self-discipline learner, and that's okay when you're not charging for it. But when you're charging tuition, people expect much more interaction, and that's best practices show that lower. And also, we are getting much better completion rates with lower capacity courses. So, I think we do have plans, though, to offer a MOOC or two, just because our faculty want to do it. But it's more of a learning exercise or will be more of a learning exercise for us and our faculty than it will be towards any long-term trend.

Timo Connor - *William Blair & Company - Analyst*

Okay, thanks. And then for FSA Title IV, it looks like your growth there is rebounding or at least flattening, and you've got a different media mix now. Is that -- as well as bad debt expense down. Is that an area where you feel like you can actually start to grow and get a little bit more aggressive, and still keep yourself under that kind of 20% -- self-imposed 20% marketing cap?

Wallace Boston - American Public Education, Inc. - President and CEO

Well, I think we can certainly grow there. There are a couple of challenges. One with the many of the nonprofits finally wising up and coming online, if you go to Google, you can see that the cost of search terms has gone up about 25% year-over-year. So we've absorbed that 25% cost without going over 20% of revenues. And it's our hope to continue to do that. I mean, we've gotten much more directional in terms of how we place our keyword purchases and our ads. And so far, our marketing team has been able to keep the costs there.

And certainly, in order to keep our tuition affordable long-term, we need to keep it at 20% or less. So while there could always be fluctuations in a quarter, we're working hard for those relationships, which are longer-term, to complete and to achieve. But, we think that running our university for the long-term is the best way to go. And so making decisions for the long-term is better, even though it may impact the quarter.

Harry Wilkins - American Public Education, Inc. - EVP and CFO

And we really do believe that we're the best value out there in the education space if you want to go to school online. And students who have to pay their loans back, as they get the word -- if the word gets out more and more about the fact that American Public University can really be America's public university compete very cost-effectively with state universities, I think we'll see more FSA growth.

Timo Connor - William Blair & Company - Analyst

Thanks, guys.

Operator

Jerry Herman, Stifel.

Jerry Herman - Stifel Nicolaus - Analyst

I know you have some disruptions on financial aid. I know you're changing your marketing mix, but can you give us some color on sort of the front-end interest in the programs, however you want to frame that? Whether it be inquiry lead flow, web traffic -- how do you see demand for your programs?

Wallace Boston - American Public Education, Inc. - President and CEO

Our interest in terms of web traffic is up and our conversion rates are down slightly. And we think the reason the conversion rates are down, particularly with civilian students, is there's a lot more competition. You know, as Harry just mentioned, we need to do a better job of getting the word out. But getting the word out through traditional media proved bad, because we got sucker-punched with these fraud and abuse students. And so now we're being much more selective, Jerry, in how we target a market and combine the interactive media with the traditional media.

And I think that if we get a quality student, their registrations on an annual basis are going to be a lot more than these in-and-out students who, quite frankly, have much more interest in a refund check than they do in pursuing an education. And so, it makes it a little tough to predict exactly whether we are tuning it and targeting it right. But we're working our fannies off here to make that happen. And directionally, it's where we are going. And we think that, ultimately, it's a win for the University; it's a win for our students; it's a win for us, and it's a win for our shareholders.

Harry Wilkins - American Public Education, Inc. - EVP and CFO

Yes, and Jerry, it will impact -- as we get better quality students, we'll have higher persistence rates. And a civilian student, an FSA student who makes it through our first course successfully, on average, takes six courses that first year with us; whereas a military student on average takes



about three courses a year. So, every civilian that we get through the process, and as we improve the quality, they're going to take more and more courses; that will benefit us.

Jerry Herman - *Stifel Nicolaus - Analyst*

Okay. And I guess we'll ping it one more time on the financial aid processing thing. Understanding you really don't know when it's going to be fixed? I guess I'm trying to understand what will fix it. Are we talking about some code rewrite? Or a patch or some software correction? Is that the fix?

Wallace Boston - *American Public Education, Inc. - President and CEO*

What you have is three software packages talking to each other. Regent is trying to take information from our PAD system and send it to the Department of Education. When we process a student now with our new software, some of the information is input by the student actually when they are applying for aid. Some is input by our people, and some Regent has abstracted from our PAD system. And that combined information file sent to the Department in a disbursements file, and the Department's COD system then disburses financial aid information. If there's discrepant information in the file or if the file doesn't give the Department the information they are asking for specifically, they'll reject it.

So, it's really -- you have to almost go through case-by-case basis with each student file that gets rejected, and figure out the programming error that took place, and then try to fix it. And it's multiple small fixes in some cases; and some cases with the origination fee, it was wrong on all the files. But we are in the process of fixing it. It's painful for us. It's painful for our students, but in the long run, we're going to have a better and more efficient and effective way to process financial aid, that both the students will like and we'll like. And it will make us more efficient.

So, we make decisions in our Company for the long-term. We don't make them to do the best we can this month all the time. We do things that we think will benefit us. And whenever you do a big change like this, this is almost 50% of our students are going through on a completely new system. We're three weeks into it and we've had some challenges, and we are addressing them.

Jerry Herman - *Stifel Nicolaus - Analyst*

Great. Thanks again, guys.

Operator

Corey Greendale, First Analysis.

Corey Greendale - *First Analysis Securities - Analyst*

Real quick, the Q3 guidance calls for total registrations to be flat with last year, revenue to be flat to up but EPS to be down. Is that entirely driven by higher sales and promotion spending? Or is there anything else going on in the cost side?

Wallace Boston - *American Public Education, Inc. - President and CEO*

It's actually just that the revenue isn't high enough to cover our increase in fixed costs from last year. It really is -- it's just -- we need more revenue.

Corey Greendale - *First Analysis Securities - Analyst*

Okay. And I don't know if you'll comment on this, but given that it sounds like the biggest issues impacting the Q3 registrations are the TA, which gets replenished in October, and the financial aid processing, which hopefully, gets resolved relatively soon, is it reasonable to think that new student registrations should be back to up year-over-year in Q4?

Harry Wilkins - *American Public Education, Inc. - EVP and CFO*

Yes, we're not giving any Q4 guidance right now, but yes, I do think the things that you pinpointed as affecting Q3 are the things that are affecting Q3.

Corey Greendale - *First Analysis Securities - Analyst*

Great, thank you.

Operator

I would like to turn the call back to Mr. Chris Symanoskie for closing remarks.

Chris Symanoskie - *American Public Education, Inc. - Associate VP of IR*

Thank you, operator. That will conclude our call for today. We wish to thank all of today's participants for their interest in American Public Education. Thank you and have a great day.

Operator

Thank you for your participation in today's conference. This concludes the presentation. You may now disconnect, and have a great day.

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