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APOL - Q2 2015 Apollo Education Group Inc Earnings Call

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OVERVIEW:

APOL reported 2Q15 revenue of $579m and net loss of $34m or $0.31 per share. Expects FY15 net revenues to be $2.63-2.68b and 3Q15 net revenues to be $690-705m.

CORPORATE PARTICIPANTS

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PRESENTATION

Operator

Good morning, and welcome to the Apollo second-quarter 2015 earnings conference call.

(Operator Instructions)

This conference call is being recorded today, March 25, 2015, and may not be reproduced in whole or in part without permission from the Company. There will be a replay of this call available through April 1st at www.apollo.edu.

I would now like to turn the call over to Beth Coronelli, VP of Investor Relations. Ms. Coronelli, you may go ahead.

Beth Coronelli - *Apollo Education Group, Inc. - VP of IR*

Thank you for joining us. Participating on the call are Greg Cappelli, Chief Executive Officer of Apollo Education Group, and Brian Swartz, Senior Vice President and Chief Financial Officer. As we discuss our results today, unless noted otherwise, we will be comparing the second quarter of FY15 to the second quarter of FY14.

I'd also like to remind you that this conference call contains forward-looking statements with respect to the future performance and financial condition of Apollo Education Group that involves risks and uncertainties. Various factors could cause actual results to be materially different from any future results expressed or implied by such forward-looking statements. These factors are discussed in our quarterly reports and Form 10-K filed with the SEC, which is available on the website. The Company disclaims any obligation to update any forward-looking statements made during the call.

Additionally, we may refer to non-GAAP measures, which are intended to supplement but not substitute for the most directly comparable GAAP measures. Our press release, available on our website, contains the financial and other quantitative information to be discussed today, as well as a reconciliation of the GAAP to non-GAAP measures.

And with that, I will turn the call over to Greg.

Greg Cappelli - *Apollo Education Group, Inc. - CEO*

All right. Thank you, Beth, and good morning, everyone.

Today, I will briefly discuss our primary business units, which, combined, currently serve over 0.5 million students globally. These include the University of Phoenix, which is going through a transition, but building a stronger foundation for future success. It includes Apollo Global, which now operates in over 40 locations around the world; and our newest business unit, Apollo Professional Development, which is building relationships with Fortune 1000 companies to design and implement new ways to effectively and efficiently train their workforce.

Our global education network drives the value of Apollo Education Group. It allows us to carry out our mission, and to improve people's lives through higher education, and to make unemployed learners job-ready, and employed learners more productive in their careers and communities. After my comments, I'll turn the call over to Brian to discuss our financial results and our outlook.

First, University of Phoenix: We're working diligently to differentiate and transform the University, which I'll speak about more in a moment. Let me quickly recap enrollments for the second quarter. We ended with 214,000 total students. We enrolled about 28,000 new students, which was a decline of 12.9% from a year ago.

Going into the quarter, and given the past trends, we'd expected the rate of decline in new enrollments to stabilize or improve for the second quarter; and that's primarily driven by enrollments during January and February time frame. There was a combination of factors that impacted new enrollments, which included our reduced level of advertising spend, which is also in conjunction with -- we saw an increase in advertising from the competitors, specifically around the holidays.

Although lead flow remained healthy, conversions from lead to enrollment were impacted. We adjusted our marketing type and spend, as well as our contact strategies this quarter. And although it's still early, we're hopeful these adjustments will yield improved results.

Over time, we will include tailored campaigns for select schools and colleges, as well as begin to showcase University of Phoenix in conjunction with our global strategy. And while we've substantially reduced our general advertising spend over the past couple of years, we continue working on a more targeted approach we hope will result in higher overall ROI in the cost to enroll, and importantly, retain each student.

The University of Phoenix is working to build a much more competitive and efficient University for the long term, with a strategy that more easily withstands short-term changes and market conditions. The team is doing this by creating differentiated colleges and programs, focused on meeting student and employer needs for the realities of the marketplace today. We're committed to attracting the students most likely to succeed, and supporting them through graduation.

The college-based strategy is being implemented by extremely talented Executive Deans within each college. They're paired with Academic Deans to ensure we are developing programs in line with competitive market dynamics. We've implemented over 40 degree programs and 50 certificates that are directly aligned with the industry competencies to provide skills for today's in-demand jobs.

In line with our strategic objective to improve student success and career outcomes, retention is a top priority. We're engaging students through the increased use of full-time faculty, where appropriate; simulations; data analytics; and intensive involvement in the online classroom by faculty and academic advisors. There are also changes in course sequencing, enhancements to how students and faculty use electronic textbooks, and access them on mobile devices.

Importantly, the University leadership is working closely with a number of key foundations and top-tier research universities to partner on projects that will enhance our understanding of how adults learn, and how we might improve adult outcomes, and enhance engagement in the classroom. We're also pleased the University of Phoenix was selected by the US Department of Education as an experimental site for competency-based education and prior learning assessment.

Finally, as we discussed last quarter, we experienced a significant disruption with respect to our new online classroom and platform. I'm pleased to say that we're on track to fix the technology platform issues, which we believe adversely impacted retention, and reduced the effect of our retention initiatives over the past year. The majority of fixes related to third-party content access have been completed.

The classroom is now again compatible with a range of supported browsers and computer operating systems, which is an area we were receiving the highest number of issues. We're also accelerating planned enhancements to improve usability, and provided additional tools and training for our students, faculty and support teams. Early indicators are positive, as we are experiencing a decrease in support calls, and improvement in net promoter scores. Over time, we expect the classroom will improve the student experience, and support retention.

As I said up front, the University of Phoenix is going through a sizable transformation, but has the strategy and the leadership in place to become a much more competitive University. We're working to offer programs relevant to today's working learners, and solving the critical needs of employers who seek, but can't fill, between four and five million jobs that are open today. The US market is very large; and although it is much more competitive than in years past, we believe University of Phoenix can increase market share by being the most trusted University for working adults in the country.

Now, to talk about Global for a minute: This is the cornerstone of our diversification strategy. We're making meaningful progress to expand our global education network, and are now serving students on six continents. We're growing in all of our key markets, and expect to be cash flow positive by year-end. We still anticipate a $400 million revenue run rate in 2015, and 20% plus annual growth over the next several years.

Just a couple of quick highlights: BPP in the UK, our largest subsidiary, continues to gain market share. We're currently serving 40 of the top law firms. Two-thirds of all accountants in the UK have studied at BPP, and it serves as a trusted partner to the top accounting firms.

At ULA in Mexico, we continue to see above-market growth in our working learner programs, with strong retention. We also recently launched three new online programs at ULA. As Australia's fastest growing education provider, Open Colleges Australia continues to expand its program base.

At Milpark in South Africa, we're currently developing online programs with new short courses launching in April. Milpark is well positioned for future expansion opportunities, as 7 of the 10 fastest growing economies are now in Africa.

FAEL in Brazil, our most recent acquisition, is reporting impressive growth in the online marketplace, adding new programs; and while still small, could potentially double enrollment this year.

At Bridge School of Management in India, we continue to expand, graduating our first cohort, and are currently launching an analytics program in conjunction with Northwestern University.

Finally, we continue to develop many new relationships in promising growth countries, and expect to further expand our Global platform in FY15.

Just quickly turning to Professional Development, which also supports our diversification strategy: This newly formed business unit is focused on developing programs that help companies recruit, retain, and develop a high-performance workforce. We estimate this rapidly evolving market to be nearly $300 billion globally.

We're fortunate to have a very talented team in place, now developing new corporate relationships at the highest levels. And we've recently met with over 50 CEOs, and are working to develop programs to specifically meet the needs of their organizations.

One early example is RockIT, an intensive 12-week boot camp focused on technology needs demanded by employers. This offering has been piloted through early cohorts, and is showing great promise, with completion rates of nearly 100%, and placements rates in excess of 90%.

Last, but not least, is operational excellence. We continue to pursue opportunities to improve our operating efficiency, and optimize our cost structure, while delivering the best possible experience and service to our students, and also to invest in future growth opportunities. We're working to ensure our costs are in line with our revenue base, which Brian will share additional detail on shortly.

In closing, we believe we're on the right path to differentiate and transform University of Phoenix, as well as to expand the students and employers we serve through Apollo Global and Apollo Education Professional Development. Our focus is on student success and career outcomes, employer solutions, diversification, and operational excellence. This is what we believe will drive our success and long-term value for all of our stakeholders.

Now I'll turn it over to Brian.

Brian Swartz - *Apollo Education Group, Inc. - SVP and CFO*

Thank you, Greg, and good morning, everyone. Today I'll review our financial results, provide a regulatory update, and share our revised outlook for 2015.

To quickly recap our consolidated second-quarter results, revenue was $579 million, operating loss was $55 million, and our net loss was $34 million, or $0.31 per share. Excluding special items, our operating loss was $17 million, and our net loss was $10 million, or $0.10 per share.

Focusing first on the University of Phoenix: Revenue in the second quarter was $488 million, with operating income of $1.4 million. Excluding special items, operating income was $32 million. In the quarter, the University enrolled about 28,000 new students, and it ended the quarter with 214,000 total students.

Second-quarter revenue per student, or RPS, was down 4.3% year over year. RPS improved sequentially due to a number of factors, including net pricing; and for those students who were enrolled, they attended more classes. We anticipate RPS to move towards flat on a year-over-year basis by year end.

Discounts as a percentage of revenue in the second quarter were 11.8%. We expect discounts to remain at about this level for the remainder of the year.

Moving on to Apollo Global: We are pleased with Apollo Global's operating performance. Second-quarter revenue was $81 million, an 18% increase year over year. This growth was the result of organic growth and acquisitions of about 28 points, which was offset by foreign currency of about 10 points.

In the second quarter, Apollo Global's operating loss was $27 million, and its adjusted operating loss was $17 million. We continue to expect Apollo Global, excluding our recent FAEL acquisition, to be operating-cash-flow-positive by the end of FY15.

With respect to our consolidated balance sheet and cash flows: We continue to maintain a well-capitalized balance sheet. At quarter end, our cash and marketable securities were approximately $835 million, and our outstanding debt was $61 million. Free cash flow for the quarter was $13 million, which was impacted by restructuring payments of $17 million. Additionally, in the quarter, we invested $29 million related to our Brazilian acquisition of FAEL, and $20 million in share repurchases.

Before moving to our business and financial outlook, I'd like to update you on the University of Phoenix cohort default rates, or CDRs. I'm pleased to announce that the University of Phoenix draft 2012 three-year CDR, which was recently released by the Department of Education, declined 540 basis points to 13.6%. The CDR is expected to be finalized in September of 2015.

The improvement is due to a number of factors, including our student repayment initiatives, and continued focus on student financial literacy and responsible borrowing. As University of Phoenix continues its transformation, we have always believed that the foundation for future success begins with a high-quality reputation; one where students have complete transparency on the front end with respect to the cost of the program, the work required to have success in the classroom, and information on how programs can lead to careers.

CDRs are one measure of quality, as students who pay back their loans are generally better off than those that don't. So, we are pleased to see this key metric continue to improve substantially over the prior year.

Now I'd like to spend a minute on our business outlook. Based on our current view, our financial outlook range for FY15 is as follows: net revenue of $2.63 billion to $2.68 billion; and operating income, excluding special items, of $200 million to $230 million. In the third quarter, we expect to report net revenue between $690 million and $705 million; and operating income, excluding special items, of $85 million to $95 million.

Regarding our 2015 outlook, I have five items I would like to mention. First: We have adjusted our revenue and operating profit ranges due to lower than previously expected University of Phoenix enrollment. The outlook reflects our current view and recent trends for student retention, which has been impacted by the new classroom transition, and our larger-than-anticipated second-quarter new degreed enrollment decline, both of which Greg discussed earlier in his remarks.

Additionally, the outlook incorporates the results of our recent re-enrollment campaign. As discussed on the prior-quarter call, the University initiated a significant re-enrollment effort, focused on supporting students as they return to class. While the University re-enrolled thousands of students in the second quarter, and at a rate above the prior year, the incremental lift was less than anticipated.

Second: With respect to new enrollments, we expect the third-quarter year-over-year rate of decline to improve sequentially from the second quarter. Currently in the month of March, our year-over-year rate of decline has moved back into single digits; however, it's still very early in the quarter, so we're not prepared to predict where the quarter will end up. For FY15, our goal remains to improve the rate of decline in new enrollments versus 2014.

In the fourth quarter, we currently expect the absolute number of new students to be about the same or slightly more than the third quarter for a couple of reasons. First, we're working to more carefully enroll students who will retain at higher rates; and secondly, the fourth quarter of 2014 has stronger relative performance and, therefore, is more difficult to be used for comparison purposes.

Third: We anticipate the University of Phoenix to end FY15 with about 200,000 students. Fourth: Excluding the impact of special items, and the potential release of uncertain tax positions, we anticipate our tax rate in the second half of 2015 to be about 44%.

And finally, fifth: We continue to focus diligently on managing our cost base. Based on current actions, we have reduced our costs by at least $150 million on an annualized basis when compared to 2014. Additionally, you will note at the midpoint of our current outlook versus the prior outlook, the flow-through impact of lower revenue is roughly 50% compared to a rate closer to 80% last quarter. Ensuring that our cost structure is appropriately adjusted, while investing for future growth, continues to be one of our top priorities.

Finally, with respect to our financial performance beyond 2015, we are focused on a variety of items, specifically three that are worth mentioning. One, continuing to drive 20% top- line growth at Apollo Global, which should yield significant improvement in profitability in 2016 versus 2015. Two, continuing to upgrade the classroom usability for our University of Phoenix students to ultimately improve retention. And three, ensuring we enroll higher-retaining students at the University of Phoenix. As we continue to move through 2015, we will provide additional color on our success with respect to these items and others, which will determine our financial performance in 2016 and beyond.

And with that, I'll turn the call over to the operator to take your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Your first question comes from the line of Phil Stiller with Citigroup.

Phil Stiller - *Citigroup - Analyst*

Hi guys. Thanks for taking my question. I just, I guess I wanted to get a little more color in terms of what you guys are seeing in the competitive environment and specifically, I think you mentioned lower lead conversions. And I'm wondering what you guys are planning to do to address that. Thanks.

Greg Cappelli - *Apollo Education Group, Inc. - CEO*

Sure, thanks. To address the question, we've been on a controlled path for a decline in marketing and advertising spend over the past couple of years. It's a more targeted approach to hopefully drive a higher ROI but we did see a spike, as I said, in competitive spend in the fourth quarter.

We did adjust our spend and our mix some, which, so far, is showing promise. It's a competitive environment but it's large and our goal is to take market share back to the college operating model in the US, so we continue to try to execute on that strategy.

Phil Stiller - *Citigroup - Analyst*

Have you guys seen the stabilization in terms of lead conversion trends? I know you mentioned that the overall new enrollment seems to have gotten less worse in March but just wondering how that's coming in terms of lead conversions versus leads?

Brian Swartz - *Apollo Education Group, Inc. - SVP and CFO*

Yes, Phil. It's Brian. Yes, the lead flow is healthy. As Greg mentioned in his remarks, the conversion rates on those which are really a function of contact strategy with students are we believe evolving in the marketplace and we are responding to those and engaging in new practices to contact students to make sure they have the right information to make the proper decisions for themselves.

Greg Cappelli - *Apollo Education Group, Inc. - CEO*

And that continues to evolve; I know it involves mobile and text and social media and things you can imagine so we're adjusting as necessary.

Phil Stiller - *Citigroup - Analyst*

Okay, and last question for me and I'll turn it over. You mentioned being cash flow positive for Global by the end of this year. I guess, Brian, what does that mean for reported profit in that segment? I know there's a bunch of other things that go in there so just try and understand what that means longer term for the margins in that segment?

Brian Swartz - *Apollo Education Group, Inc. - SVP and CFO*

Yes, absolutely. First of all, just to clarify my comments, it's operating cash flow positive excluding our recent acquisition, just because there's kind of a partial year and so it did distort the results a bit, but in terms of profitability, we do -- so we provided, Phil, as you'll recall and it's in the press release that we released this morning, a supplemental non-GAAP measure of adjusted operating income.

We also supplementally provide the impact of Open Colleges, our Australian operation because of the nature of the revenue recognition down there. As they grow, it actually creates some near-term pressure for us but our deferred revenue grows and it's good for the long term in terms of profitability. Obviously, none of that impacts cash flows so all of the disclosure is there. We do expect significant improvements in profitability in 2016 when compared to 2015 from the Apollo Global team.

Phil Stiller - *Citigroup - Analyst*

Great, thanks.

Greg Cappelli - *Apollo Education Group, Inc. - CEO*

Thank you.

Operator

Your next question comes from the line of Sara Gubins with Bank of America Merrill Lynch.

Sara Gubins - *BofA Merrill Lynch - Analyst*

Hi, good morning. Thank you.

Greg Cappelli - *Apollo Education Group, Inc. - CEO*

Morning Sara.

Sara Gubins - *BofA Merrill Lynch - Analyst*

Retention was worse than we expected in the quarter. I'm wondering given the LMS fixed, do you think we should start to see those declines improve in the back half of the year and is it really mostly LMS related or is there something else going on?

Greg Cappelli - *Apollo Education Group, Inc. - CEO*

That's a great question. Yes. We have worked very hard to make the fixes as quickly as possible and do them the right way. Our hope is to begin to see improvement in retention and when we do that, we will certainly report on it. Are there other things that are driving decreases in retention? We don't think so at this point.

We had some really good results over the last couple of years driving higher retention for a number of reasons that we've discussed publicly so we're really focused on making sure those net promoter scores come up to the right levels that we're actively in discussion with. Everybody involved that is not only enrolling but taking care of students along the process and making sure they're having a good experience and the right experience at the University of Phoenix.

Brian Swartz - *Apollo Education Group, Inc. - SVP and CFO*

Sara, it's Brian. Just to add a little color on the outlook and retention in the quarter. With respect to persistence, which I know is the way you calculate for the quarter, keep in mind reenrollments, which we -- I did make some comments on that those although, ahead of the prior year, were below what we had expected in light of some of the campaigns that the University of Phoenix teams ran.

That would positively impact persistence because those are not counted in new enrollments. In fact, they are counted in ending enrollment so that might have impacted the current quarter. You should take that into consideration.

And secondly, the only thing I'd add in terms of our revised financial outlook, both revenue and profit. The upper end of that range contemplates basically more improvement in retention in the back half of this year in part driven by the classroom as well as other initiative that the University of Phoenix team is running and to the extent we have less pick-up on that in the near term, we would anticipate being at the lower end of that range.

Sara Gubins - *BofA Merrill Lynch - Analyst*

Got it. Okay, and then on the competitive environment, you mentioned more advertising from others. Was that more traditional non-profit schools or more proprietary schools that were ramping up their ad spend?

Greg Cappelli - *Apollo Education Group, Inc. - CEO*

I think it was both but clearly, the winter term for many traditional students -- excuse me, schools and institutions saw a spike in advertising to try to fill those classes and those programs and we'll watch that very closely. It's an area that we are making adjustments to and know very well, so it was really in both, but yes, we did see it in the traditional space as well.

Sara Gubins - *BofA Merrill Lynch - Analyst*

Okay, and then just last question. Could you talk about where you see room to continue to lower costs? It sounds like it's ramping quite a bit versus prior expectations that were in guidance. Just kind of the main buckets of potential cost take-outs. Thank you.

Brian Swartz - *Apollo Education Group, Inc. - SVP and CFO*

Yes, Sara. First of all, I do want to be clear. Our goal and we will -- well, bottom line is we will always align our cost structure for our revenue outlook. There could be lags in terms of when those costs are, or those benefits are realized but that is absolutely our goal and I think we've shown we've done that over the last couple years.

In terms of opportunities, other areas that you mentioned, I think there are lots of opportunities, particularly in the area of automation within our operations, which not only increase automation but actually enhance the student experience, whether that's through class scheduling, application, processing, faculty scheduling, core scheduling, those types of things. So we do see further opportunities there and we'll always diligently manage the cost structure.

Sara Gubins - *BofA Merrill Lynch - Analyst*

Thank you.

Operator

Your next question comes from the line of Peter Appert with Piper Jaffrey.

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

So I mean, you guys have been so successful in managing the costs over the last couple of years. And I'm just wondering if maybe, or I guess the question is, have you gone so far now that it is impacting the enrollment and start results and that's part of the reason that we just can't seem to find a bottom here in terms of the starts. Perhaps you've cut too far on the ad budgets and the other supports pending programs. What do you think, Greg?

Greg Cappelli - *Apollo Education Group, Inc. - CEO*

It's a good question, Peter. I mean, we're looking at that closely. We have been on a controlled path. This has been in the plan.

The key has been enroll students that can have success in the University of Phoenix. They obviously are transforming into eight or nine colleges that are very, very focused on working with their markets and employers to drive the best results.

And I'm excited about that while continuing to automate, like Brian said, as well but we have to look at the advertising closely as well and make sure that it's in the right areas. Obviously, lots is changing with social media and mobile and contact strategies as well but we have a really good team; they're looking at it very closely and we're looking at that overall level of spend.

We have worked hard to try to drive higher ROI costs to acquire and retain a student. It -- you know this from being in the industry a long time, there are always opportunities. If new enrollments are the only goal without, respect to the retention and the success of that student, that certainly is possible within this industry.

And we're being very, very careful with all of the work we've done on the front end, all the transparency, all of the initiatives around student success to try to make sure we're not doing that, so I'm confident that our team is going to get that right. I think you bring up a great point. We're looking at that very closely and our goal, certainly, is to get back on plan to make sure that we're enrolling the number of students we thought and to have success more importantly with the students to stay throughout their term and graduate.

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

Got it. Thank you and then one other thing. On the Global business, it wasn't clear in terms of your comments on this earlier. Is the expectation that you can be cash flow positive on a full year basis in FY16?

Brian Swartz - *Apollo Education Group, Inc. - SVP and CFO*

Yes, so the comments, specifically, 2015 will be operating cash flow positive; in terms of 2016, I would certainly expect operating cash flow to grow. We have to look at investment levels of spending on CapEx and otherwise but absolutely, this year on an operating basis, I would expect that to continue next year. We'll have to look at free cash flow once we work through more operating plans for next year.

Greg Cappelli - *Apollo Education Group, Inc. - CEO*

Just remember part of the beauty and the plan with Global has been to expand globally but in a capital-light fashion, right? We have been able to strategically enter countries and then grow them organically rather than make very large acquisitions that suck up a lot of capital and a lot of cash flow, so we're excited about what we're seeing around the globe. And we will begin to tie more closely into the network our domestic operations as well so they can benefit from that network effect.

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

Got it and Brian just to be clear on that. So the operating cash flow positive does not incorporate the negative cash impact of the Open College growth, so from a free cash flow standpoint, it's still negative potentially in 2016?

Brian Swartz - *Apollo Education Group, Inc. - SVP and CFO*

Yes. Let me try to be clear, Peter. All of the Open College's impacts with respect to their revenue recognition did not impact cash flow at all. It impacts reported operating profit but not cash flow. My comments on 2016 between operating cash flow and free cash flow is just a function of CapEx level. That's why Greg made a comment.

I don't expect CapEx to increase substantially next year as we sit here today for Apollo Global because principally, we are focused on capital-light or capital efficient businesses. But we haven't worked through all of those plans next year so on an operating cash flow basis, simply before CapEx I would expect it to be positive this year and grow next year and we'll have to just evaluate CapEx plans in the coming months.

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

Great, thank you.

Greg Cappelli - *Apollo Education Group, Inc. - CEO*

Thank you, Peter.

Operator

Your next question comes from the line of Corey Greendale with First Analysis.

Corey Greendale - *First Analysis Securities - Analyst*

Hi, good morning.

Greg Cappelli - *Apollo Education Group, Inc. - CEO*

Good morning, Corey.

Corey Greendale - *First Analysis Securities - Analyst*

Just one other quick question on global given that there's a pretty meaningful drag from currency right now. Can you just give us some sense of what growth rate we should expect for Global over the next couple quarters -- revenue growth that we should expect for the next couple quarters?

Brian Swartz - *Apollo Education Group, Inc. - SVP and CFO*

Yes, so the current growth rate, we were up 18% this quarter. That would have been about 10 points higher, closer to 28% if currency was flat with prior year, so it is significantly impacting us. I think that less currency rates move even further which they obviously might and they will certainly move around, that 10 point differential between reported growth and actual growth is a good proxy, I think, for Q3 and Q4.

Greg Cappelli - *Apollo Education Group, Inc. - CEO*

We are naturally hedged with our expense obviously.

Brian Swartz - *Apollo Education Group, Inc. - SVP and CFO*

Yes, yes.

Corey Greendale - *First Analysis Securities - Analyst*

Yes, understood and then a question on the retention. I think in talking about the Q4 new students, you said you're working to more carefully enroll students who will retain. And Greg, in answer to Sara's question, you said that you think retention is basically doing what you want excluding the impact of the learning management. So can you just kind of square those things and why you think value needs to be changing the profile of the students you're enrolling?

Greg Cappelli - *Apollo Education Group, Inc. - CEO*

Well, look, no, my comments were around if you look at the successful historical results of the University of Phoenix, we enrolled dedicated working adult students that retain, right? And my comments are only that we will occasionally deal with something either in the industry or the marketplace that can impact that.

You know this, that the economy can have an impact at certain times; employment levels, there can be swings in that but overall, I'm excited about what I'm seeing with the college operating model strategy about the competitive nature of each individual college, not just under one University brand. Working to make sure that each college understands their market share competition, right?

What they need, what products and services, working with employers to develop the right programs to take market share back and to retain students so that they can have success. Not everybody is right for a four-year program or two-year program, as I've said in the past, they've developed stackable certificates so there are different things that affect retention.

And my hope is that despite any short-term impact from the classroom or technology issue or something outside of the economy that we can put ourselves on a good path to enroll the best students that are appropriate for each college and University of Phoenix and retain them.

Corey Greendale - *First Analysis Securities - Analyst*

Okay, understood, so given the various moving pieces, just I realize it's early to get too specific about 2016 but history would suggest that when providers try to target higher retaining students, that can impact new students for a year before that anniversaries. So just for clarification, do you think there's a reasonable chance we should be thinking about negative new students in FY16?

Greg Cappelli - *Apollo Education Group, Inc. - CEO*

Those weren't part of our remarks, frankly. The point that we're trying to make, you -- marketing aside, we're trying to do is fundamentally put the building blocks in place to build a more competitive University. And that starts with excellent people throughout the University, excellent levels of service, high Net Promoter Scores, and the right programs and services tied into careers.

And this has been a major transformation for the University of Phoenix that operate more as a singular University and we're really, really excited about what we're seeing; as we said in the past, it's not going to be a perfectly smooth ride. There's going to be some sits and starts, and we encountered one this quarter but what we're doing is setting it up for long-term success to be more competitive.

Corey Greendale - *First Analysis Securities - Analyst*

Got it. Realize that it's a tough environment out there and I appreciate the answer. Thanks Greg.

Greg Cappelli - *Apollo Education Group, Inc. - CEO*

Thank you, Corey.

Brian Swartz - *Apollo Education Group, Inc. - SVP and CFO*

Thanks Corey.

Operator

Your next question comes from the line of Denny Galindo with Morgan Stanley.

Denny Galindo - *Morgan Stanley - Analyst*

Good morning, I have a couple more questions on starts and retention. First you -- last quarter, you sounded more confident that starts would improve from the previous quarter. Can you talk about the pace of the decline that you saw this quarter and were starts kind of worse later in the quarter? Is that when maybe some of the competitors kicked up their marketing spend? Maybe you can give us more color on the pace of starts?

Greg Cappelli - *Apollo Education Group, Inc. - CEO*

Sure. I don't think it was necessarily an issue of later in the quarter for us. We saw some things happening before the holidays from a competitive standpoint that certainly carried into the New Year to some extent.

We don't get into really timing month by month for starts, but I will say that we are starting to see some impact from some of the adjustments that we've made in our marketing this quarter. Where that ultimately ends up, we're not commenting on that yet but we're hopeful that's beginning to have an impact.

Brian Swartz - *Apollo Education Group, Inc. - SVP and CFO*

Hi Denny, it's Brian. I just -- for clarity, too, I think on our last call, we actually did not comment specifically where Q2 new enrollments would come out, in part because of the seasonality. It's so back-end loaded, so obviously, we would have liked to have done better than the down 12.9% but as we go into Q3, at least March is looking better than that.

Greg Cappelli - *Apollo Education Group, Inc. - CEO*

Our goal is to get starts back to flat and growing as soon as possible without sacrificing anything on the quality front, which will be done by employing this college operating model structure with a more competitive product and value proposition in the marketplace.

Denny Galindo - *Morgan Stanley - Analyst*

And then on the impact of the LMS system, I mean, you talked a lot about the impact on retention. Did that have any impact on starts or is that just a completely separate issue?

Greg Cappelli - *Apollo Education Group, Inc. - CEO*

It's possible that it did, absolutely. And you have -- I should mention one other thing, from a timing perspective, being careful not to, what you don't want to do when you have an issue that's impacting students is run out and spend a whole lot of money on advertising to attract more students into a classroom where there's been some problems. So there is a bit of a timing issue there as well.

As I said that has been an incredible operation to get that to where we want it today. There's more steps throughout the Spring that will happen but that should get better and better in terms of the student experience and the whole initiative was done in the first place to tremendously modernize the experience for the student which we expect will have a positive impact going forward.

The timing, we can't pinpoint to a quarter but there's better data. There's better analytics. It should be a better overall experience for the user and frankly, for faculty and staff at the University of Phoenix.

Denny Galindo - *Morgan Stanley - Analyst*

Okay, and then on discounts, it came in a little higher just like you said it would but is this a potential lever that you could pull to get starts growth back up or is it something you prefer to stay away from?

Brian Swartz - *Apollo Education Group, Inc. - SVP and CFO*

I think it is a lever that you can certainly utilize. What we want to do is think about utilizing that for the benefit of students and we've seen really nice success in the last 18 months or so is the rollout of our Phoenix Scholarship Reward Program, where you can -- where students can earn up to $10,000 off their degree, which is pretty substantial if they start as a freshman with us.

It's upwards of 15%, 18% off the cost of a program, generally speaking in that ballpark, so we like having those kind of programs in place, tying investments we're making in net pricing to retention over time for students and we've been pleased with those results, so --.

Denny Galindo - *Morgan Stanley - Analyst*

And then lastly on retention, you mentioned that some of the reenrollments really didn't come in as much as you expected. Is this an area where competitors are targeting some of the students that have left? Is that a factor in the reenrollments being down or is it simply pure kind of company-specific issues for you guys?

Greg Cappelli - *Apollo Education Group, Inc. - CEO*

I think that was a specific issue around into the classroom and frankly, the biggest upgrade in technology we've probably had in two decades but ultimately, should provide a much better experience, as I said. We don't have information that competitors came in and targeted those students. It's a competitive environment.

We're going to have offerings some others don't have. We are certainly working very, very hard to listen to both students and very importantly, employers, and the confidence you're hearing in our voice of getting this right long term, if you do that, there are millions and millions and millions of jobs that employers are frustrated they want to voice in the education process.

They want that connected into the programs in the classroom and for universities as well, not just training organizations and I'm confident that by listening and acting accordingly and providing a great competitive product and value proposition out there in the marketplace, both on a B2C and importantly for us B2B initiatives, that we're going to have long-term success.

Denny Galindo - *Morgan Stanley - Analyst*

Thanks for taking my questions.

Greg Cappelli - *Apollo Education Group, Inc. - CEO*

Thank you.

Operator

Your next question comes from the line of Jeff Silber.

Jeff Silber - *BMO Capital Markets - Analyst*

Yes, it's Jeff, how are you?

Greg Cappelli - *Apollo Education Group, Inc. - CEO*

Hi, Jeff.

Jeff Silber - *BMO Capital Markets - Analyst*

Good morning. Just a follow-up actually from an earlier question. I think, Brian, you'd mentioned the $150 million in annualized cost savings. Can you tell us where those will come in terms of which line items?

Brian Swartz - *Apollo Education Group, Inc. - SVP and CFO*

Yes, I mean basically, what that number represents is if you take the midpoint of our current financial outlook range, obviously, there's a low and a high as well, I think you calculate somewhere about $120 million, give or take $125 million or so of cost reductions year over year. Some of that is variable; some of those are fixed costs. When we annualize that number, it is at least $150 million and it will positively impact 2016 on an annual basis versus the 2014 cost base.

Jeff Silber - *BMO Capital Markets - Analyst*

Again, I'm sorry. Which specific line items are we talking about?

Brian Swartz - *Apollo Education Group, Inc. - SVP and CFO*

It's a variety of line items; you can actually see it if you look to the math. It's a combination of instructional, admissions, advisories, down marketing all the line items I think are down year over year with the exception of admissions and advisory because of the impact of our international operations.

Jeff Silber - *BMO Capital Markets - Analyst*

Okay, great and in your prepared remarks, you talked about some adjustments you've been making to your advertising approach, some more targeted. Can you give us just some examples of what those are so we can kind of be on the look out for that?

Greg Cappelli - *Apollo Education Group, Inc. - CEO*

Yes, we're not going to go into a lot of detail there because some of it's obviously, we feel competitive but what I would say is that the marketing team is working closely with each individual college, right, and leader at the colleges or the universities to make sure that we are, our mix is dialed correctly.

For instance, it's very important for us. We know that some of our best students come directly in through the University of Phoenix website, where we have analytics and tools and other ways to measure potentially their level of success and interest on the front end, right?

So that's an example of how you would dial a little bit more in certain areas of offline spend versus digital or online, and there's other areas where mobile is playing a bigger role today. I think probably for all colleges and universities and adjusting for how students want to communicate or potential students, right, about the process of enrolling, so there's a number of factors. Hopefully, that gives you some flavor what's happening.

Jeff Silber - *BMO Capital Markets - Analyst*

All right, great, and just a quick numbers question. What should we be modeling for Capital Expenditures this year?

Brian Swartz - *Apollo Education Group, Inc. - SVP and CFO*

Yes, the percentage of revenue, it will trend a little closer to 4% of revenue. Obviously, we expect to get leverage on that as we stabilize and return to growth.

Jeff Silber - *BMO Capital Markets - Analyst*

All right, great. Thanks so much.

Greg Cappelli - *Apollo Education Group, Inc. - CEO*

Thanks, Jeff.

Operator

Your next question comes from the line of Paul Ginocchio with Deutsche Bank.

Paul Ginocchio - *Deutsche Bank - Analyst*

Great. Brian, I was interested to hear you talk about trying to improve, make sure you get a high retaining student. Can you just go back to orientation?

Is that not worth -- not improved your retention and persistence or am I just thinking about it wrong? And then as kind of a follow-up on persistence, do you think the better job market is having an impact on your persistence? Thanks.

Greg Cappelli - *Apollo Education Group, Inc. - CEO*

Those are good questions, Paul. The more -- if you remember, we were one of the first organizations in the country to put in a trial period and actually mandate several years ago that students have the experience of understanding what they're getting into because it probably requires 18, 19, 20 hours a week of work to ensure success in the classroom. And we put that into place, really primarily, to make sure that students were not going into debt before they had an understanding and complete visibility on the front end of what every program is going to cost, where the job opportunities are, and frankly, what it's going to take to have success in the classroom and where we've seen the biggest impacts is exactly where we thought.

Brian mentioned that our cohort default rates have come down, over the years, from the mid to upper 20%s down to below 14%. That is, the implications of that are very, very important long term for the University of Phoenix, along with all of the other quality things we've done on the front end to improve in that area, so that has been extremely important for us and the biggest reason that we did it.

Now we also have made some adjustments to that program, which is primarily in the colleges now on ground. And obviously, we give people a trial period now for three weeks to make sure that they're -- they have the same opportunities, right, to understand the experience before they go into debt. And the more -- that's frankly, the most important area for us.

The retention strategies to retain students longer have been around the sequencing, right, the experience in the classroom, full time faculty. Frankly, aside from the glitches that were in the platform, the experience from that should improve as well overall, tying in things like the guidance system for careers. There's a number of things that we've done that we've seen some success on the retention front to date.

Paul Ginocchio - *Deutsche Bank - Analyst*

Is -- do you think that the improved job market is having a negative impact on persistence?

Greg Cappelli - *Apollo Education Group, Inc. - CEO*

That's possible. I looked at that for 20 years historically and it's really hard to make an exact claim, right, on the labor markets. We've done work to historically look at what weekly employment levels are, monthly data points, and it's possible that as the employer market strengthens in certain areas that, that can have a short-term impact.

Usually, it's the delta of when things are moving quickly, whether you're adding a lot of jobs or subtracting them before it stables out but we're not -- that's not an excuse for us. It's a huge market. There's a ton of opportunity.

You've got to have the right competitive programs, the right value proposition for us. That's a college by college strategy and it's absolutely involving employers at the highest level to make sure you're delivering what they're looking for.

That doesn't happen overnight. It's a transition for us but we're plugging away and there will be light at the end of the tunnel when we get it fully in the marketplace and operational.

Paul Ginocchio - *Deutsche Bank - Analyst*

Thanks and just a quick one for Brian. The year-to-date based on your third quarter guidance for EBIT, it's down pretty significantly; it was down the first half but the implied guidance for the forth quarter in EBIT is basically flat year on year. Is that the cost cuts coming through or was that -- I'm just trying to understand what makes EBIT flat versus the year-to-date significant declines? Thanks.

Brian Swartz - *Apollo Education Group, Inc. - SVP and CFO*

Keep in mind, Q4 there is pretty significant seasonality in the Apollo Global businesses which you can see through some of the supplemental data we've provided last year. We also expect some growth in Q4 in the University of Phoenix non-degree line items which would positively impact EBIT as well. Seasonally, that's higher in Q4, just given the nature of the programs and then the Summer timeframe of when students take them but we do expect growth in that line item as well.

So also and I guess finally, keep in mind, there is obviously a range on the EBIT and the revenue and I know Greg made some comments earlier, Paul, that describe what are the assumptions at the upper end of that range and what the assumptions in the low end of that range which would be important for you to obviously make some -- a formal point of view on.

Paul Ginocchio - *Deutsche Bank - Analyst*

Thanks, Brian.

Operator

Your next question comes from the line of Jerry Herman with Stifel.

Jerry Herman - *Stifel Nicolaus - Analyst*

Hi guys. Good morning, everybody. Greg, I just wanted focus on demand again because it appears that while its been choppy for a long time, it's taken another downturn here and I guess I'm wondering if students aren't appreciating your differentiation, value proposition, especially in light of a competitive environment and especially what happened with advertising, actually suggesting that you're losing some share rather than gaining some share. So how do you feel about that, especially as it relates to value proposition and maybe even talk about pricing?

Greg Cappelli - *Apollo Education Group, Inc. - CEO*

Yes, that's a good question Jerry. I look at the overall market. It's not like there's many lighting the world on fire in the overall market so as far as losing share, I don't think there's many standout situations. There are some that we would look at and say, wow, they're taking a lot of share although there are some.

I think that we look carefully now at where the biggest growth opportunities are. We know that elements of information technology are growing nicely in the country and we'll emphasize that. We know that elements of healthcare are growing nicely and are focused on building that area and rebuilding that area.

We know that elements of -- even in the area of business, where there's opportunities and excitement. And we have a better understanding of the markets, the market share the competitive set, what it takes to your point price value because there are those that are the highest value to them is just low price and there are those that want more services and attention and technology and so on and so forth.

So we look at all of those things as closely as possible and are developing products and services around that. Now, I will say that, to answer your original question, I mean, frankly, we're not finished, right, at the University of Phoenix. We have the fixtures in place but the plumbing is not all hooked up, right? I mean, we are developing a plan, college by college.

It takes people, it takes strategy and processes, it takes the programs which are being developed and put in place and there are many things that come along with that, to make sure that the user experience is there, to make sure that the connection to employers is there. So I have to be honest with you, no, we're not getting the results we want yet but it's not all completely implemented yet either.

And I expect that the most important thing for our domestic operations is to execute on their very solid plan this year to get that done, fully get it in the marketplace and then we can much better assess the success that they are having or not having at that point in time.

We expect them to have more success and take market share when the plan is fully implemented in the market. There are elements of it, as I said, that are hooked up but we need to complete the full implementation.

Jerry Herman - *Stifel Nicolaus - Analyst*

Just a question about the Professional Development unit and help us differentiate that versus your corporate relationships and ultimately, we want to get to some representation of how sizable those businesses are, where you are interfacing with corporations in a way that's driving job opportunities. Help us frame that if you would.

Greg Cappelli - *Apollo Education Group, Inc. - CEO*

That's correct, and we have a division that's centralized, call it, professional sales which are meeting with executives and employees in the right areas at corporations and companies all over the country and now the world. And there's some great exciting wins that we're not -- we don't report on every single quarter that help us understand where their needs are.

And if you think about historically how we've operated, really, what we did to solve everybody's needs was to put them in a degree granting program at the University of Phoenix. Now that will continue to be a very important area and the University is very involved in understanding what employers' needs are but there are other areas that employers are telling us that they need help as well.

Rockit is a good example of that, a three-month IT bootcamp and we are working to build other avenues to train their workforces and employees appropriately for them. But frankly, we didn't have the tools in our tool box to do it previously. So Professional Development is working over the entire entity with Global, with the domestic degree granting operations and non-degree to make sure that we have the right tools in our tool box to serve employers.

Jerry Herman - *Stifel Nicolaus - Analyst*

Great. Let me just ask one last question, if I can. I hope you can appreciate this one. I mean, you guys have worked hard to get the business turned around but over the last couple of years, there's been a change in your Board composition, your ownership structure. I'm just wondering if you're incrementally taking a broader, more aggressive approach through enhancing shareholder value?

Greg Cappelli - *Apollo Education Group, Inc. - CEO*

You know what? We evaluate that every single quarter with our Board of Directors. Right now we're very, very focused on our strategic plan, finishing it, getting into the marketplace but absolutely, we want to enhance shareholder value.

You do that, right, by attracting the right students in all of your entities and trying to grow those entities for the right reason, making sure that we are positioning ourselves well for long-term future success but those are discussions that we have in the Boardroom every quarter about how do we maximize shareholder value. This has been an industry that's gone through a tremendous amount of change and evolving pretty quickly and we're determined to have success long term and also drive long-term shareholder value.

Jerry Herman - *Stifel Nicolaus - Analyst*

Great. I'll turn it over.

THOMSON REUTERS

Greg Cappelli - *Apollo Education Group, Inc. - CEO*

Thank you.

Operator

Your last question comes from the line of Nick Nikitas with Robert W. Baird.

Nick Nikitas - *Robert W. Baird & Co. - Analyst*

Yes, thanks. Most of my questions have actually been asked but I guess, just a quick one, Brian. You mentioned reenrolling a smaller number of students than you guys anticipated post the LMS issue. Just looking forward, is that an opportunity to essentially bring back more in future quarters or at this point, is it kind of any student who hasn't reenrolled is likely gone?

Brian Swartz - *Apollo Education Group, Inc. - SVP and CFO*

It's always an opportunity and the model is such and has always been such that we constantly have reenrollment campaigns in place. Given that some of the challenges we had last Fall with the classroom that we always talked about on this call and in prior calls, since we were able to fix those as the ad plan kind of post-January time frame, we put some concerted effort and more focus on the reenrollment campaign.

We were ahead of prior years, I mentioned, which is good but was short of where we hoped to be so we're constantly doing that. We're constantly calling -- students generally frequently come in and out of the student body just because life happens and we have teams in place that work. So I think it is an opportunity amongst others and we keep it front and center.

Nick Nikitas - *Robert W. Baird & Co. - Analyst*

Okay, thanks.

Greg Cappelli - *Apollo Education Group, Inc. - CEO*

Thank you.

Brian Swartz - *Apollo Education Group, Inc. - SVP and CFO*

Thank you.

Operator

There are no further questions at this time. I'll turn the call back over to the presenters.

Greg Cappelli - *Apollo Education Group, Inc. - CEO*

All right. Thank you, everybody, for your time this morning, your patience and certainly, your interest in Apollo. We look forward to continuing to update you as we execute on our strategy and we'll talk to you soon. Thanks so much.

Operator

This concludes today's conference call. You may now disconnect.