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APOL - Q3 2015 Apollo Education Group Inc Earnings Call

EVENT DATE/TIME: JUNE 29, 2015 / 9:00PM GMT

OVERVIEW:

Co. reported 3Q15 revenue of $682m and net income from continuing operations of $48m or $0.44 per share. Expects FY15 net revenue to be $2.60-2.62b.

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PRESENTATION

Operator

Good afternoon. My name is Eric and I will be your conference operator today. At this time I would like to welcome everyone to the third-quarter Apollo earnings conference call.

(Operator Instructions)

I will now turn the call over to Beth Coronelli, Sr. Vice President of Investor Relations. Please go ahead.

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

Thank you for joining us. Participating on the call are Greg Cappelli, Chief Executive Officer of Apollo Education Group, and Joe D'Amico, Interim CFO here at Apollo. As we discuss our results today, unless noted otherwise, we will be comparing third quarter FY15 to third quarter FY14.

I'd also like to remind you that the conference call contains forward-looking statements with respect to the future performance and financial condition of Apollo Education Group that involves risk 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 on 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 this 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 GAAP to non-GAAP measures.

I will now turn the call over to Greg.

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

All right, thank you, Beth. Good afternoon, everyone. Thanks for taking the time to participate in our conference call today. First, what I'm going to do is turn the call over to Joe D'Amico, our Interim CFO, to review our third-quarter financial results, with color around the key operating metrics. And then I'd like to talk through the next phase of our transformative strategic plan on which we're about to embark at University of Phoenix, our primary asset.

I'll also briefly update you on Apollo Global -- we're going to continue to grow the top line in excess of 20% -- as well as our professional development division where we just completed an investment in one of the leading IT boot camps in the nation. And then I'll close with a discussion on our outlook and then we'll take Q&A. Joe, welcome back and let's begin with your review.

Joe D'Amico - *Apollo Education Group, Inc. - Interim CFO*

Thank you, Greg. Good afternoon, everyone. It's actually great to be back at Apollo working closely with you and all of the talented people throughout the organization.

To quickly recap our consolidated third-quarter results, revenue decreased 14% year over year to $682 million, below the lower end of the outlook of $690 million we provided in our second-quarter call, mostly due to lower retention and new enrollments, which were slightly below our expectations. Operating income was $91 million, down 22% year over year. And net income from continuing operations was $48 million or $0.44 per share.

Excluding special items, operating income was $102 million and net income from continuing operations was $58 million or $0.53 per share. Operating income was above the top end of our outlook range of $95 million as a result of our efforts to appropriately align our cost base with our revenues.

Focusing on the University of Phoenix, revenue in the third quarter was $561 million with operating income of $103 million. We enrolled 29,400 new students in the third quarter, down 13.3%, with total degree enrollments of 206,900, a decrease of 14.5% year over year.

Third-quarter revenue per student, or RPS, was down 4.6% year over year, comparable to the second quarter and in line with our expectations. RPS for the fourth quarter is expected to be flat on a year-over-year basis.

Discounts in the third quarter were 12.7% of revenue. They trended higher year over year, about 1 percentage point above our expectations, with an increase in students accepting retention-based scholarships. We continue to expect discounts as a percentage of revenue for the full year to be approximately 12%.

In the third quarter, University of Phoenix operating margin was 18.3%, or 19.4% excluding special items compared to 21.2% in the third quarter of 2014.

Moving on to Apollo Global, third-quarter revenue was $110 million, an increase of 9% year over year. The year-over-year growth rate on a constant currency basis would have been over 20%.

In the third quarter, Apollo Global's operating income was $6 million, comparable to a loss of $14 million in the third quarter of 2014. Adjusting for depreciation and special items, it was $14 million in the fourth quarter. Apollo Global results were in line with our expectations and we continue to anticipate Global will be cash flow breakeven for FY15.

Turning now to our operating expenses, in the third quarter total operating expenses excluding special items decreased approximately $74 million or 11% year over year, primarily as a result of lower enrollments, as well as the continued reduction of our cost base. Based on our actions taken to date we've decreased our operating expense run rate when compared to FY14 by at least $200 million on an annualized basis.

With respect to the consolidated balance sheet and cash flows, at quarter end our current cash and marketable securities were approximately $778 million and our outstanding debt was $55 million. Free cash flow for the quarter was $38 million.

Now I'd like to spend a minute on our business outlook for the year. Based upon our current view, our range for FY15 is as follows -- net revenue of $2.6 billion to $2.62 billion, a decrease from our prior range of $2.63 billion to $2.68 billion, and operating income excluding special items of $190 million to $200 million compared to our prior range of $200 million to $230 million. Again, we decreased our outlook due to lower anticipated retention and enrollment.

Excluding the impact of special items and potential release of uncertain tax positions we anticipate our rate to be about 43% for the full FY15. We anticipate the University of Phoenix will end FY15 with roughly 195,000 to 200,000 students.

In the fourth quarter, we continue to expect the absolute number of new students to be about the same as the third quarter. It's important to note that the fourth quarter of 2014 had stronger relative performance and therefore has created a more difficult comp.

Greg will provide additional color on our outlook for FY16 and beyond as he closes the call. And with that, I'll turn the call back over to you, Greg.

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

All right, thanks, Joe. And I'm sorry we didn't note earlier, we're also joined by Greg Iverson, our Chief Accounting Officer. He'll be with us for the Q&A portion. So, welcome, Greg.

And with that as a backdrop, now I'd like to spend some time walking you through additional elements of the strategy that University of Phoenix President Tim Slottow and his team have spent significant time on working on this year. The next phase of the plan solves issues that have been plaguing University of Phoenix, frankly, since the inception of Axia College back in 2004. At that time the domestic higher education industry, particularly the for-profit sector, was consistently growing in the double digits with significant growth in online delivery.

Pricing power was strong, consistently at 5% or more. The regulatory environment, while certainly never to be taken lightly, was significantly less complex than today. And the political climate was neutral for this sector. Today all that's obviously changed. Working learners have many more choices and competition for online students has increased dramatically.

In 2010 our sector received a wake- up call oin the regulatory front with a relentless pounding of the issues focused on reining in any bad actors. Some of the criticism of the industry was well-founded and some perhaps not as much. But, nevertheless, it became absolutely clear to us that only those institutions willing to be leaders in the areas of regulatory compliance and transparency, those willing to put students first above all other priorities, would have the opportunity to continue at that point to serve in the US higher education system.

We met with and listened to many key Congressional members in both the House and Senate, state regulators, attorneys general, leaders within the Department of Ed and the White House. We listened, we learned and we reacted with speed and vigor. We met with the challenges head on. And the reforms we instituted were significant and lasting on many levels and I just want to name a few of the actions that we took.

Beginning in November 2010, we were one of the first organizations to change recruiter comp, well before it was mandated. We implemented responsible borrowing tools and calculators beginning in the spring of 2011 to make the cost of college transparent to prospective students and to encourage students to make smart financial choices. We were among the first to put early surveillance systems in place to stop any attempted financial aid fraud schemes.

We implemented student orientation in the fall 2010, which we made mandatory as a three-week program for freshman to help them better understand the rigors of our program before we allowed them to enroll or take on financial aid. And we built upon that and what we learned around orientation in 2014, introducing a risk-free period for incoming freshmen. And we rolled out new career tools beginning in 2013 to directly connect education to careers.

Now, I mention some of these things because, while they were clearly appropriate, there's no doubt these initiatives also took a toll on our operating and financial performance during the period, a period where the reputation at the University of Phoenix was tarred by the broader environment and damaged in the public eye. Looking over the landscape today there are multiple examples of educational institutions either in serious jeopardy or literally going out of business. It's clear how important it was to take the bold steps we did, which allows us to be a more respected institution today.

It's the bedrock and the foundation that needed to be put in place first, even prior to instituting our strategic plan for University of Phoenix that will eventually get us back to growth. We've dramatically lowered our student cohort default rate from almost 30% several years back to now below the entire industry average.

Over the last couple of years we've seen some improvement from time to time in retention. But clearly, we're not satisfied with the results which have been below our expectations and the standards to which we hold ourselves accountable. As a result, collectively we are doing a deeper, strategic review and taking more dramatic steps.

Improving student outcomes including graduation rates is our top priority. It's the right thing to do for students. It's critical for our reputation and should also result in a superior economic model for shareholders.

The University of Phoenix, with support from Apollo, has reviewed and studied numerous options around improving retention and completion rates. Going forward, in conjunction with our new college operating model we've discussed in the prior quarters, the University is preparing to take immediate action. Let me highlight several key areas and then I'll go into detail for each one.

They include incorporating diagnostics and admissions criteria in student pathways back into the University, retiring certain associate degree programs with lower retention rates, further refining our campus strategy to focus on major metro markets, moving away from the complexity of starting students weekly, moving away from proprietary and legacy IT systems, driving self-service to enhance experience and efficiency.

First, and probably most impactful of those, we're developing the front-end diagnostics and the admissions criteria for newly entering students. And this is intended to help ensure that prospective students are better prepared for the rigors of undertaking a college degree program at University of Phoenix, and will therefore complete their programs at a higher rate. We'll also help provide additional pathway opportunities to these students if necessary prior to enrolling them into the University.

The implementation of diagnostics and admissions criteria will have a negative impact on enrollment in the near term but we fully expect retention improvement over time from this initiative as we ensure we are enrolling students best prepared to succeed in our rigorous programs. This will also help existing students receive a higher overall quality experience within our classrooms.

Second, we plan to retire certain associate degree programs that were primarily developed for the Axia model over a decade ago which have lower retention rates, and from a financial standpoint, actually inferior returns on capital. These will be replaced with stronger, more career-focused pathways that offer certificates and four-year bachelor's degrees in key growth areas of the market.

Third, the University is analyzing our campus footprint around the country and ensuring we place our focus and investment into fewer markets where we can continue to have a strong regional presence, while still keeping a national but more refined presence throughout the country. While this will allow us to operate in a more efficient manner we also see opportunities to invest in the areas of hybrid or blended learning offerings, which we've had success inwith internationally. This allows for deeper engagement at the local level with major employers as well as non-profit organizations to enhance opportunities for our students, faculty and alumni.

Fourth, we will be consolidating start dates, moving away from starting new cohorts every week at University of Phoenix. And while this may impact the timing around new enrollments, it's expected to reduce complexity and costs with the focus on increasing student satisfaction. This will also provide increased time to prepare incoming students, allows for more effective class sizes, as well as improved faculty scheduling.

We've also recently implemented best practices and sophisticated workforce management tools and processes to better balance work loads and increase the productivity of our enrollment teams across the University, leading to better student service, increased operational efficiency, and cost savings.

Fifth, we plan to move away from certain proprietary and legacy IT systems to more efficiently meet student and organizational needs over time. This means transitioning an increased portion of our technology portfolio to commercial software providers allowing us to focus more of our time and investment on educating and student outcomes.

While Apollo was among the first to design an online classroom and supporting system, in today's world it's simply not as efficient to continue to support complicated custom designed systems particularly with the newer quality systems we've more recently found with off-the-shelf providers that now exist within the marketplace. This is expected to reduce costs over the long term, increase operational efficiency and effectiveness, while still very much supporting a strong student experience.

Finally, the University is in the process of developing enhanced capabilities in the areas of student self service, including financial aid, academic planning, scheduling, and the application process. This is also focused on improving the student experience and supporting our strategic objective to drive operational excellence. We will begin rolling out a number of these self-service capabilities later this year.

While there's more work to do, significant progress is already being made to refocus University of Phoenix to best meet the needs of the marketplace. This approach was designed to help the University continue to differentiate and to more tightly focus on student outcomes, performance and accountability for each individual college within the University. We believe the initiatives I just reviewed, in conjunction with the college-based approach, will help the University of Phoenix to strive to earn again its reputation as the most trusted provider of career-relevant higher education for working adults in the country.

Before I move on to the broader outlook, let me just quickly touch on Apollo Global where we are working to, one, deliver world-class experiences and outcomes for students and employers; two, expand our footprint as well as accelerate our organic growth, building a network leveraging our global presence and sharing best practices and to improve operational efficiency and effectiveness. At Global we anticipate revenues of about $400 million in 2015. Our goal is to grow revenues over the next five years by 20% annually on a constant currency basis.

We're pleased with this segment of our business and look forward to continue to diversify our overall revenue mix. You'll notice that we began providing enhanced metrics for Global earlier this year. And we will continue to try and provide ways for you to appropriately analyze and value this important segment for Apollo. As Joe said, Global will be cash flow breakeven this year and we expect to be GAAP profitable in FY17.

The third key area of our business is our newest division, professional development, and I just want to touch on it briefly. This provides significant opportunities for Apollo, supporting our strategy to diversify beyond reliance of Title IV funding, and really is central to our plan to develop employer-friendly focused solutions that provide the link between education and talent development.

We've recruited some impressive talent in this division. We continue to meet with Fortune 500 companies all over the country to ensure that we're building educational programs that are relevant to their training needs. We'll be providing more information on this division in the coming quarters.

I just want to quickly highlight our recent investment in tThe Iron Yard, which is a leader in IT coding education. There's an increasing world-wide demand for highly qualified individuals with technology skills, and Tthe Iron Yard responds directly to this market need. With their proven, immersive three-month training programs in software development and design, combined with our current IT boot camps through RockIT, we intend to expand to new domestic and international markets. This strongly supports our approach to provide programs to help students achieve their career and business goals in both degree and non-degree granting programs, and to provide employers with the skilled individuals they need to grow.

To close, I'd like to share some thoughts on our broader outlook. The actions we're announcing today will undoubtedly put pressure on our new student enrollment, revenue and operating margin in FY16. But we also firmly believe that with these actions we will begin to see improvement in retention and graduation rates at a higher level, a better student experience, and ultimately improvement to the University's reputation. It should also result in a better economic model for our shareholders over time.

To offset this initial decline in enrollment we plan to take aggressive cost actions to align our costs with revenue until retention begins to improve, driving our operating margins back to the 15% to 20% range over the next three to five years. I know there will be questions around the details. We wanted to tell you as early as possible about where we're headed. However it's early in the process of building out our FY16 year budget and financial plan.

Let me tell you what I am able to share with you today. We're initially modeling about 150,000 total students at the end of FY16. That's about 50,000 students less than FY15, which we then expect to stabilize in 2017 and grow thereafter.

We're working now on identifying all areas of our cost base which we believe should allow us to reach a minimum of $150 million in operating profit in FY16. Again, a lot is going to depend on how quickly we see results from implementing our front-end diagnostics and new entrance requirements. We're building in some, but not a substantial amount of retention improvement in FY16. We do expect to see retention kick in more starting in FY17 and beyond. And with respect to pricing, we're assuming it remains flat for modeling purposes throughout this period.

On the Apollo Global front, there's nothing we see from a structural standpoint that won't allow it to keep growing and also achieve margins in the 15% to 20% range over time.

Finally, I'd like to quickly address our capital position. We're mindful that we have a significant amount on the balance sheet available for use. I want to assure you that we regularly discuss the appropriate uses of our capital with our Board. We care deeply about the long-term returns on this capital. We're obviously going through a period of transformation where there's a higher than normal volatility within our sector and our Company, and we will always look for the best uses of capital to drive long-term shareholder value.

I'll look forward to your questions. And, Operator, if we could begin the Q&A. Thank you.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

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

Corey Greendale - *First Analysis Securities - Analyst*

Hey, good afternoon, everyone. Greg, I realize that you're still mid planning so I'm just going to try a couple things here. First of all, pricing, part of all of the noise in the sector has been that students, I think, have become more debt sensitive, more price sensitive. It sounds like price is not, at this point, one of the levers you're talking about moving meaningfully for next year. Can you just talk about how much price may be on the table and why you're not thinking about moving that more?

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

Sure. On the new college operating model every Executive Dean is looking at their markets from a competitive standpoint, and they are advising on whether they need to increase, decrease, keep price the same. We no longer look at that across the board and decide on a price increase for the entire University because all of the colleges, frankly, are in areas where you can imagine some are more competitive than others, they have different products and different competitive sets, and they just much more data on how to look at it individually at this price.

Now, last year when they did that analysis, there actually was a small overall price increase for the University, which will start to kick in probably in the next quarter. But that is really conducted in a thorough way on an annual basis. And at this point for modeling purposes we see it staying flat, but certainly we will update you as they do their work throughout the year.

Corey Greendale - *First Analysis Securities - Analyst*

And I know that, among other things, I think you're a student of the Clayton Christiansen philosophy, at least very much aware of it. And I know that it's hard to totally change your model. Given that with each passing year it seems like more changes have to be made, it sounds like you're doing all the right things in terms of outcomes. But how are you thinking about whether it would make sense to make a more radical pull-the-band-aid-off kind of change and drastically get away from degree programs and do much more shorter-term boot camp things, more just-in-time badge things? How are you thinking about that?

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

It's a great question. The way I think about it is, really, from a degree granting standpoint we are pulling the band aid off, if that's the way you want to categorize it. We are exiting many of the associate programs that were begun ten-plus years ago in certain areas, where there's lower outcomes, it's more difficult.

There's been a tremendous amount of effort through technology, through investments made in the depth of learning and different areas to try to improve retention in degree granting programs. We're taking a more radical approach in the degree granting area with the diagnostics and the requirements to sit in one of our classrooms so that everybody is prepared and can have the same experience. And by the way we think that will improve many things including the reputation of the University over time. This was a University at one point that had above average graduation rates in many different categories. We would like to try to get it back there.

Now, to your second point, I also, we also value the non-degree granting world. We have spent countless hours sitting with Fortune 500 CEOs and their executive management teams. And it's very clear also that while there is still demand for degree granting programs, that there is a tremendous and growing need for non-degree programs and certificates, as well.

Both the University of Phoenix and Apollo Group are developing programs to satisfy those needs. We're studying and understanding their workforce, about the way they acquire talent, how they train it, how they place it inside the organization, and how they can get a better ROI. Because the reality in this country is that 50% or more of the time -- corporations spend their hard-earned dollars recruiting employees -- over 50% of the time they never get the ROI back on the investment they made because it's a misfit.

We're taking that into consideration, all of that, and we're developing shorter-term programs, some of which can stack into degrees, both at the Phoenix level and then at the Apollo level, as well. Does that answer your question?

Corey Greendale - *First Analysis Securities - Analyst*

It does. I have one more quick one, if I might. And I should just say, by the way, that I'm not a believer that the degree as the qualification of record is going away. It's more a question about University of Phoenix and how you're positioned.

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

Absolutely.

Corey Greendale - *First Analysis Securities - Analyst*

The last quick question I had is just, I think I heard you say you're going away or potentially going away from weekly starts. Given that the world seems to be at least moving in the direction of competency-based education and more flexibility, I understand operationally why you're doing it but it seems counterintuitive to the way demand is going. So, could you just address that?

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

Yes, I can. We are also working on competency-based education programs at a couple of our institutions including University of Phoenix, number one. Number two, competency-based doesn't mean that you have to start students 52 times a year -- 50 or 52 times a year.

We're doing a lot of research, we have a lot of data back from students, and, frankly, we believe that a fewer number of starts -- there will still be plenty but a fewer number of starts -- will help us organize the cohorts better. There will be better scheduling and completeness of the cohort, so that once you announce a course you're going to run it for sure. There will be better staffing around that cohort, as well. And we think better service levels and better outcomes.

We've done a lot of research on it. There will be plenty of starts for students to start. It's not like there's only going to be a start two or three times a year. But we just think 50 is too many at this point, doing it weekly. There will also be some breaks that are built in that we feel are necessary, that students have talked about with us over the past year. A lot of work was done in this area and we feel pretty good about the basis of where we're going to.

Corey Greendale - *First Analysis Securities - Analyst*

I appreciate all of the details, Greg, thank you.

Operator

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

Denny Galindo - *Morgan Stanley - Analyst*

Hi there, good afternoon. A lot of these changes seem to be moving away from things that leverage your scale, whether it's fewer start dates, less proprietary technology, reducing the geographic presence, differentiation by college. How do you think about that tradeoff between reducing these things that only you can do as the largest university and cutting costs? And then what are the areas that really use your scale under the new strategy?

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

Look, we're not really trying to de-lever the scale advantages, from that standpoint. But let me tell you what the biggest advantage is to levering scale. You spend dollars strategically to recruit students into your system, and if the students are staying, that is the true advantage to levering any platform or scale.

Now, it's true that we've had locations all over the country for many years but what we're doing is we're not guessing. We're looking at lots of data, we're talking to corporations, we're talking to groups of individuals in sessions where we could understand their needs. And we're just talking about getting out in front and positioning the University of Phoenix so it can have the most amount of success.

The scale really comes when you can lever the amount of money that you're spending on marketing, recruiting, the costs to acquire a student and the length of time that person stays with your cost basis. And we very much believe that that's possible going forward. But the very first thing we need to do here is to make sure we're getting the right kinds of students sitting in the classroom and retaining at a higher level so everybody can have a great experience.

Denny Galindo - *Morgan Stanley - Analyst*

Okay, that's helpful. One other one on capital management. It sounds like you're shrinking the organization to the right size, and there's a little bit of uncertainty over the next two years as you finish your plan of what that size is. Does this mean you're going to shift away from repurchases and more towards acquisitions and, say, Apollo Global, as a use of capital over the next two years until you have a better idea of where the right size for the organization is?

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

I didn't say that. What I said is, given the circumstances, we look at that capital every single quarter with our Board. I think there are times when share repurchases have in the past and will continue to make sense. We look at a pyramid of every dollar we use, whether it's in Global or, frankly, we're investing back into certain areas of our domestic operations, or the B2B solutions which we've been spending some money on at professional development, as well. We look at those returns in order.

And we do think that there's an appropriateness at certain times for share repurchases, as well, and that will continue to be part of the dialogue going forward. It's hard for us to signal exactly how much we're going to spend and in what areas because we're not allowed to do that, but it certainly has been part of the conversation and is every quarter when we meet with our Board.

Denny Galindo - *Morgan Stanley - Analyst*

Lastly, along the same lines, when you think about preferred countries or regions to deploy some of that capital, are there any areas where you would pay a higher multiple than somewhere else just because it fits in with the strategy more? I'm thinking, I know Brazil is a place where there's been some assets available and it's starting to become a pretty large market. But are there any places that you think you'd go after a little bit more aggressively?

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

I don't really think of it in terms of multiples although I do appreciate what you're saying there. The multiple is usually a function of growth and capital efficiency that we find. Recall -- you might know -- that in Apollo Global we've kept it very capital efficient. Even with the newer University of Phoenix strategy, we very much want the cash conversion cycle to be efficient. It's always been a cash flowing vehicle because of the way itsit's been built and run. That's exactly what we're doing internationally, as well.

So, when we find areas that we believe can grow faster with the same efficiency, yes, that affects, in this case, the multiple or the price you pay. However, we do sophisticated analysis to look at long-term value creation and it has to be there. We walk away from way more things than we ever end up buying or engaging in because we simply don't think that's possible. So, the returns have to be attractive. We risk and adjust for the country -- risk, as well -- the political environment and growth opportunities. And we see some exceptional opportunities around the world.

I might add that Apollo Global is just starting to realize the benefits of being a network together, that when we do go look at an asset in different locations now, we bring with us the existing operator in the region. And they already quickly can identify what needs to be done to increase the returns before we even acquire the asset. They are just getting to the point where they are able to get leverage off their own size.

Denny Galindo - *Morgan Stanley - Analyst*

I'll hop back and get back in the queue.

Operator

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

Sara Gubins - *BofA Merrill Lynch - Analyst*

Hi, thanks, good afternoon. First, could you help us think about why you think 150,000 is the right amount to end up at? Given your student base, do you already have this size or something in the ballpark that are at the diagnostic levels that you're thinking about requiring?

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

There's been a lot of work done to this point and analysis and looking at the student base. And you're right, there's no magic starting point. But through the analysis and data, we think that's a good starting point. Remember, we need to model so that we can look at our cost basis. If it ends up being more than that, okay. But we're looking at that from a starting point for our costs so that we can get this organization back to 15% to 20%.

We're not going to be at the mercy of the market whims over the next couple years in terms of is it going to be up a little bit or down a little bit. We have an idea of where we want to go, where the bottom is, the costs that are going to come out to equal our revenues, the levers, if you will, in the model for that. And what can vary that we'll be watching very closely are the rate of increase back up and retention versus the cost. Those are the two really key levers. And, of course, as I said before, pricing and the average revenue per student.

So, we're going to be looking at those very closely. But what we absolutely do want to do is improve the overall position of the University of Phoenix, its brand, its reputation, and its ability to recruit at a lower cost going forward. When I look back 15 years ago, when this organization had 100,000 students there was a 20%-plus margin. Now, it was a different day, for sure, and the dynamics, as I pointed out at the beginning of the call, were different, but it's doable. So, we're focused on the data and we'll be updating as we go along. It's a starting point.

Sara Gubins - *BofA Merrill Lynch - Analyst*

Okay, great. And then following up on costs, if I think about your comments, it sounds to me like we would expect to see starts somewhere in the ballpark of down about 35% next year, which would translate to revenue probably down about 13%. And then that would translate to costs being down about $300 million. That's taking out about another $250 million of fixed costs.

I wanted to see if that sounds about right, where you think that would come from. And then if the goal is to get back up to 15% to 20% margins, presumably we would expect more cost cutting to come in FY17 and beyond. Thanks.

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

Sara, what we're going to do, our feeling is it's very difficult to come out and explain a strategy like this if you don't try to give some parameters around what to do with the model. And I totally appreciate that, having sat in that seat. What I do want to say is we are very hard at work building the budget and the financial plan for all of FY16. You are exactly right, The starts, along with the pricing and THE the revenues, need to be balanced with costs, and we are very focused on that.

As far as the categories of the costs, it's across the board of the entire organization. The organization was working hard together already on this, so it's not a surprise. And that's our goal. And our goal is to make sure that we are driving towards the 15% to 20% margin over the next three to five years. But we are, on our fall call, going to be going through our budget in more detail.

Joe D'Amico - *Apollo Education Group, Inc. - Interim CFO*

Sara, this is Joe. I just wanted to add that our rate of spend now on an annualized basis, or at least the cost savings, as I said in the script, is down $200 million. So, we have a good start toward this coming year. And we continue to work on things with self service and other IT changes that will help us be more efficient.

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

It's across the entire organization. And, by the way, I totally understand the magnitude of the numbers you're talking about and we're working on it now.

Operator

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

Paul Ginocchio - *Deutsche Bank - Analyst*

Hi, Greg, thanks. Just the first one on, I think you said that total enrollment would be flat Q on Q or did you talk about new enrollment against the fourth quarter?

Joe D'Amico - *Apollo Education Group, Inc. - Interim CFO*

The absolute number would be about flat with Q3. But the comp is higher for Q4 of last year, so the new degree enrollments will be down more.

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

And there will be some impact from our new plan in the fourth quarter already, which is affecting it some, in terms of personnel and recruiters, and so on and so forth. So, there's some of that in there, as well.

Paul Ginocchio - *Deutsche Bank - Analyst*

So, new enrollment is going to be flat Q on Q.

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

Q on Q. That is correct. That's our estimate at this point.

Paul Ginocchio - *Deutsche Bank - Analyst*

And then there was a spike in other losses and I was just wondering what that was related to.

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

Could you say that one more time? I'm sorry, Paul, we lost you for a second.

Paul Ginocchio - *Deutsche Bank - Analyst*

It seemed like there was higher other losses in the quarter versus a year ago. I was just wondering what those are -- not Global, not UOP?

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

I'm going to ask Greg to take a look at that in the information and we'll come back during this call.

Paul Ginocchio - *Deutsche Bank - Analyst*

Okay. And then can you talk about which associate programs you're closing and how much of enrollment they are?

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

Yes. At one point associate degree programs spiked to over 50% or maybe even 60% of total enrollment. But we brought that down over the past few years, as we talked about in the past. So, of that 50,000 chunk that we'll be taking out it's a meaningful percentage of it. It's not all of it, by any means, but there's a meaningful percentage in there. And then those that will graduate out of the program.

The University of Phoenix intends to offer some very career-focused areas of associates where it makes sense. We're just not going to be recruiting on a wide scale basis across the board, blanketing, if you will, the market in that area for associate programs anymore. So, there will be some areas of focus going forward but it will be a lot smaller.

Paul Ginocchio - *Deutsche Bank - Analyst*

Okay. And you talked about Global growing 20%. Was that an organic number that you're talking about or does that include acquisitions?

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

Yes, it's organic. And I look at, there have been acquisitions, but any acquisition that we make, the reason we make it is so we can grow it actually at an increased rate organically by leveraging everything. We call it One Apollo throughout the organization. And that actually is working for us so we will continue to do that and only make acquisitions where it makes sense.

Paul Ginocchio - *Deutsche Bank - Analyst*

And of that $400 million run rate for revenues what percent is roughly Brazil?

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

Brazil is very small for us at this point but it doubled in size year over year, so it is growing very rapidly. It's very capital efficient. We're excited about that market. I know that there's some issues in certain areas of it that we have not gone into, but we know the market well and we're excited about our prospects down there.

Paul Ginocchio - *Deutsche Bank - Analyst*

What percent of your students in Brazil get government financing?

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

It's very small at this point. Almost none.

Paul Ginocchio - *Deutsche Bank - Analyst*

Okay, thank you.

Operator

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

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

Thanks. Greg, the decision to further consolidate the campus network, is that mainly a cost-driven strategy?

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

No, although it will significantly help costs. Honestly, it's modernizing the University. That's what we are doing in all of the areas. We are literally in discussions with corporations about their workforces. We're doing town halls around the country in certain areas, trying to make sure we understand.

We are going to continue to be in most of the big metro markets with our campus system, but the leadership at University of Phoenix has looked very closely at where do we need to be, where can we be most effective. Let's invest in those areas. Let's make sure we're offering hybrid programs, things where we've had lots of success overseas.

We're not trying to be everything to everyone in every market that worked 20 years ago. We're picking the most important markets around the country, investing and going after those on a more local basis. And we think we can be more effective doing it.

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

Back to the cost issue, I'm just scratching my head a little in the context. You've been in cost reduction mode now for three, four years. You've been very successful and aggressive at that. I'm just concerned how much more there is to do and when you start doing damage to the franchise.

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

Peter, I'll say this again. And you were one of the original followers of the Company. 15 years ago this Company had a 20% margin at 100,000 students. I think the whole key here is -- not to do damage -- to improve the reputation.

The thing you can't do as responsible fiduciaries of capital, loaners' capital, and, frankly, the responsible owners of the University, is you can't, in this case, have it both ways. I'm talking for us. I'm not saying for anybody else in the industry. We want to meaningfully improve outcomes. We've done everything we can on the regulatory front to be leaders and we will continue to do so.

THOMSON REUTERS

Now we want our reputation back like we used to have as an operator of the University that has high outcomes. Tim Slottow and his team knows how to do that. It's a bold plan, I agree. But if you're going to do that you need to be mindful and considerate of costs, as well. And we believe that you can do both.

Now, this is an organization that hand built a lot of things over the years and we're getting better and more efficient, and we're going to aggressively go after those costs. This plan actually calls for them to reinvest additional dollars into key areas -- into faculty, into the teaching model and experience, into hybrid areas. So, there's a lot of stuff where we are going to be increasing investment but by getting it out of certain areas where, as I said before, having our own systems has worked for this Company in the past. But there's really good stuff out there now that's even being built as we speak. So, a year from now, we're putting a tremendous amount of time, effort, capital into technology where we can be levering not just being the sole provider of that, and taking that money and reinvesting it back into the educational experience, as well.

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

Does the business stay cash flow positive in FY16?

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

Yes.

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

Great. Thanks, Greg.

Operator

Your next question comes from the line of Phil Stiller with Citibank.

Phil Stiller - *Citigroup - Analyst*

Hi, thanks for taking my questions. Greg, you're making a lot of changes with the University of Phoenix right now. I just wanted to get a better sense in terms of when these decisions were made and what the timeline is for implementing it. As we think about enrollment in FY16, when should we see a fully annualized impact of all these changes?

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

Okay, good questions. Tim Slottow, the President, the Executive Dean, his team of personnel have been doing research on the University while running it over the past year. So, these decisions were made, frankly, during the quarter where conclusions were made that if we want to achieve our goals on retention, outcomes, graduation rates, that this is the path that they feel will best lead us to the promised land there. We know there's short-term consequences to doing this but all of us who are here believe that it's the right thing to do.

If you are graduating students at the national average, there's not a lot of argument about your tax status. By the way, we feel like we have the ability and the capabilities to do this. I know it possesses a near-term challenge but with that, down the road comes benefits. It's a better economic model when it's working appropriately.

You spend less money, not more, to acquire students because you're getting more referrals, as we used to have in the past. And it's just time for this organization to start moving down that road. Sorry, the second part of your question?

THOMSON REUTERS

Phil Stiller - *Citigroup - Analyst*

Just trying to get a sense in terms of how long it will take to make these changes.

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

They are in the process of making the changes now. You'll see some of the impact, actually, in the fourth quarter, as I mentioned. FY16 is when the bulk of the students will come out. There will be stabilization in 2017 and growth beyond.

Phil Stiller - *Citigroup - Analyst*

Okay. Can you give a little more color in terms of what admission requirements you're going to start imposing on new students?

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

Honestly, not yet. And that's from a competitive standpoint. They are actually using some really neat diagnostic tools, technology. And there obviously will be requirements, based on a number of different factors, to get into the University. And we will talk about that in the fourth quarter on the conference call. They're just not quite ready to do that yet.

Joe D'Amico - *Apollo Education Group, Inc. - Interim CFO*

Greg, I might add that some of the students that might not make it through the admission standards, we're going to actually counsel them and help them figure out how do they get their education/ So, some might go back to a community college or there might be other programs available right here, there might be certificate programs, there might be other things that either we or others offer that will help them, and then come back to the University.

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

What we found from doing that in some of our Global businesses is some very loyal people who said thank you very much. They went through that and they actually ended up enrolling later on with higher success rates.

Phil Stiller - *Citigroup - Analyst*

I think it makes sense. The last question and I'll turn it over, just clarifying on the margins, the guidance for this year implies a 7% or 8% operating margin. And it seems like the initial commentary on 2016 is similar in that ballpark. Just trying to square that with the 15% to 20% longer-term margins. Are you going to get there through further cost reductions or can you only get there if you grow revenues off that base?

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

First of all, I don't disagree with your comments there. What I would say is, think about what my comments on the levers were. You're right, the students come out, an initial block of costs come out. And then there are more efficiencies that we have identified already and that will be taking place, along with continuing to work on the cost front going forward.

However, you do need eventually retention to go up. So, we're expecting that. We think we're building in plenty of time for the stability for that period and then also new students to flatten out and begin to grow. So, it's that combination, when you look at the model, happening over the next couple years, and then margins starting to improve. So, it is a combination of all those things, including the costs.

Phil Stiller - *Citigroup - Analyst*

Okay, great, thanks.

Operator

Your next question comes from the line of Michael Tarkan with Compass Point.

Michael Tarkan - *Compass Point Research & Trading - Analyst*

Thanks for taking my questions. Just a couple here. Can you talk about your exposure to gainful employment, just what percentage of your programs would be affected by the new rules? And I have a follow-up.

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

Our exposure at this point is very small. Everybody has exposure to it. When I say that, I mean we feel very good about our positioning with the pass/fail line now. There will be this warning zone, and we're looking at that closely.

But certainly, we feel like all the work that we've done -- I mentioned the bedrock. We wouldn't even be talking about putting this plan into place, phase 2, if you will, of this plan for University of Phoenix had we not gotten the first piece done and complete because that is entry to the dance. So, I feel very good about our positioning right now overall on the regulatory front and with respect to things like 90/10 and certainly gainful employment, which we believe in.

Michael Tarkan - *Compass Point Research & Trading - Analyst*

Any sense as to what percentage of programs would either fall in that warning zone or below that, at this point?

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

I don't have the data right in front of me but I know that everybody at the University feels comfortable that we are in good shape on gainful employment at this point. I don't have the warning zone data for you yet. And we're actually still all waiting for some data to get, as well, that we need in certain areas. But, certainly, I feel like that will not be a limiting factor to impact the speed at which the students come out in this plan, stabilize and then regenerate.

Michael Tarkan - *Compass Point Research & Trading - Analyst*

Okay. And then last one for me, just from a high level perspective here, the new start growth number that you're guiding to essentially for the fourth quarter, it looks like it's down around 24% year over year, 70% from the peak in 20009.

THOMSON REUTERS

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

I think that's a little higher. It's closer to 20% or 21%, I think it is, if it's flat. But you're in the ballpark.

Michael Tarkan - *Compass Point Research & Trading - Analyst*

Okay. So, my question is, I've been following the Company for a long time, we've heard about a lot of transformation plans year after year. I know Brian has left but at what point is it in shareholders' best interest for the Board to take a harder look at management? Thank you.

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

Sure. We're working very closely with the Board. We are in close dialogue. It is our perspective and our belief that we want the best people doing the right things for students, number one. Number two, just remember that the universities have their own personnel that run the universities, drive their own strategies, thatstrategies that Apollo is certainly here to provide the capital and the support. They have their own Board of Directors. But we're all here to work together and to get the job done.

And as I said before, management can change over time, but regardless of who's running the businesses in this area there's a couple things there that you need to be mindful of. Number one, the industry has changed very dramatically. Number two, absolutely have to do the right things in the areas of regulatory and compliance. And, number three, you always have to put the student first.

I know it's been a challenging five years in the industry and for this organization, having been the largest player / But we're not taking short cuts to get there and we're going to try to always do things the right way. Thank you for your question.

Michael Tarkan - *Compass Point Research & Trading - Analyst*

Thanks.

Operator

Your next question comes from the line of Jeff Mueller with Baird.

Jeff Mueller - *Robert W. Baird & Co. - Analyst*

Thank you. Greg, now you're firming it up that you've put the bedrock in place to enable phase 2 of the transformation. But, at least as I understood it maybe two years ago, I would have interpreted your comments at that time that you would have thought you would have been back to growth by now because of the transformational changes that you've made thus far. The first part of the question is, what's the post mortem on what you got wrong over the last two years. And then the second part is, as you talk about getting back to growth in 2017, any additional detail on what provides you or can provide investors confidence in that.

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

Yes, Jeff, thank you. When I look back, I think there were, as I said before, some really well-intended efforts to bring retention higher in this organization, but always doing so under the original premise that this has been a pretty open platform to do that. So, lots of good intentions to make improvements in retention in the overall model in a very tough and competitive and changing landscape, as we know.

We didn't get those results in terms of taking anybody in and helping them to graduate and achieve things on a national scale, a national level, thatlevel that would be more in line with the averages. Now, we're taking the next step to do that. We've tried a lot of things to do it. It hasn't gone to the level of expectations that we believe are possible and so we're taking the next steps there. I'm sorry what was the second question?

Jeff Mueller - *Robert W. Baird & Co. - Analyst*

Where does your confidence come from for 2017? And how do you instill that in investors in terms of getting back to growth in 2017? Is it that you're culling the programs that are currently in decline, you're preserving the things that are working, you're generally putting a better product into the market? You referenced that a lot of this was data informed. I know some of that's competitive but anything that you can share with investors to provide them some of your confidence.

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

We're making a lot of changes, actually, a lot more than perhaps it sounds like we've done in the past, not just with the diagnostics and the requirements to get in. But the college operating model is just starting to kick in. That's taken a year for the University of Phoenix to develop it. As I said, the University of Phoenix has its own capable management team. Which, by the way, has changed dramatically over time.

But what I would say is that it's a combination of the college operating model, it's a combination of the new diagnostics, the pathways, the technology, the things that we're putting in place that we do expect to get results by 2017 in terms of stability and growth.

Joe D'Amico - *Apollo Education Group, Inc. - Interim CFO*

Let me give you one example that might help. In the past, we had one pathway for most of our students. They came in at the associates level, they took nine-week courses, and we gave them a lot of support. What we found is that by setting two tracks, one for students that might not be quite as well-prepared and one track that's for students who are better prepared, we found that the lift in terms of retention has gone up when compared to those old models.

We have data actually supporting that. And we've done some pilots that are giving us confidence that it looks like we can achieve some of the objectives that we've laid out. But we also know that retention is not one thing. You have to do many things. And over the years, we have taken a lot of steps, including, for example, full-time faculty; for example, changing the sequence of courses, putting games in courses that help learners learn, putting in predictive analytics, eliminating learning teams in courses.

The things that we've done we've learned from and now we're packaging it altogether in hopes and with an expectation that we get the results that we're seeking. And I'll say one other thing -- there's been a lot of change in management at the University of Phoenix and actually throughout the organization. So, there's some different kinds of thinking, perhaps, and greater accountability going into this.

Jeff Mueller - *Robert W. Baird & Co. - Analyst*

Thank you. Appreciate the perspective.

Operator

Your next question comes from the line of Jeff Silber with BMO Capital Markets.

Jeff Silber - *BMO Capital Markets - Analyst*

Thank you so much. I know it's late. Can you give us an update on the HLC review at the University of Phoenix, please?

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

We do not have an update at this point. We are still in the process of waiting for our final result there and we'll update you accordingly.

Joe D'Amico - *Apollo Education Group, Inc. - Interim CFO*

Shouldn't be long though.

Jeff Silber - *BMO Capital Markets - Analyst*

Okay, that's great. And, I'm sorry, I know you gave soft color for where you think the framework is going on a model for the next few years, but I just want to double check. When you say enrolled and stabilizing in 2017 potentially, what do you mean by stabilizing?

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

We talked about the number of enrollments going to 150,000, and stabilizing means at that level. So, staying there and then working its way higher. And, look, that could vary throughout the year of 2017, but that's the framework we're providing at this point. As I said, we'll be giving some more color next quarter. Does that make sense?

Jeff Silber - *BMO Capital Markets - Analyst*

Yes, it does. I just wanted to clarify. Thanks so much.

Operator

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

Denny Galindo - *Morgan Stanley - Analyst*

Hi, guys, just one quick follow-up. Just on the diagnostic test that you're doing on the startups, I was wondering if you had any feel for of the people that don't get admitted because they fail this test, how many would be counseled to these other options and how many would, say, go to one of your other programs, like a certificate program or some of the other things you're doing, or if it may be too early to create some buckets?

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

Sure. Thank you very much for the question. It is absolutely not just a test. There are a number of things in the diagnostics and the requirements that have to be met, including, in some cases, your age and other areas. But I won't go into a lot of detail there as they're in the process of developing and putting those in place.

What I will say is that when you look at those factors about everything that's going into that, I should say those are all part of the factor that goes into determining how many people will be screened out or not. Obviously there's a determination that's going to be made around, with any student, whether they're appropriate for entrance, and to be in class with other students. And if not, we will look at every student where it makes sense to counsel them through a pathway, either to stay within the Apollo family or, frankly, as Joe said before, outside of the organization.

We just want them to have the best experience. We want them to do the best thing for themselves. And at that point that they're successful we'll have other opportunities, if they are successful outside or inside the organization in these pathways to come back to the University of Phoenix. There's a pilot starting in July and we're going to learn and adjust, as appropriate.

Denny Galindo - *Morgan Stanley - Analyst*

That's it for me.

Operator

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

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

All right, thank you, everybody, very much for your time today. We appreciate it. We will update you accordingly and we'll look forward to talking to you soon. Take care.

Operator

Ladies and gentlemen, this concludes today's conference call. You may now disconnect.
