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APEI - Q1 2013 American Public Education Inc. Earnings Conference Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the first quarter 2013 American Public Education, Incorporated, earnings conference call. My name is Caris and I will be your coordinator for today.

At this time, all participants are in a listen-only mode. Later, we will conduct a question-and-answer session.

(Operator Instructions)

As a reminder, this call is being recorded for replay purposes. I would now like to hand the call over to your host for today, Mr. Chris Symanoskie, Vice President of Investor Relations. Please proceed.

Chris Symanoskie - American Public Education Inc - Associate VP IR

Thank you, operator. Good evening, everyone, and welcome to American Public Education conference call to discuss financial and operating results for the quarter ended March 31, 2013. The presentation materials for today's call are available in the Webcast section of our Investor Relations website and are included as an exhibit to our current report on Form 8-K filed earlier today.

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

Actual results could differ materially from those expressed or implied by these forward-looking statements as a result of various factors, including the risk factors described in the risk factors section and elsewhere in the Company's annual report on Form 10-K filed with the SEC, the Company's



quarterly reports on Form 10-Q filed with the SEC, and the Company's other SEC filings. The Company undertakes no obligation to update publicly any forward-looking statements for any reason, even if new information becomes available or other events occur in the future.

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

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

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

For the three months ended March 31, 2013, net course registrations increase 9% compared to the prior-year period, and net course registrations by new students declined 7% year-over-year. We are encouraged by better persistence among students who have successfully completed three or more courses, and by recent trends indicating an improvement in the volume of net course registrations by new students, in particular by new students using VA benefits, Federal Student Aid, and Tuition Assistance.

We believe we're on the right track with the refinements we're making to our marketing mix of media and outreach spending in order to improve qualifications of our incoming students. We continue to shift and redirect our marketing efforts for the purpose of attracting students with greater potential college readiness and ultimately higher success rates. To accomplish these goals, we began to adjust our marketing mix away from traditional media in favor of interactive media and more targeted relationship-oriented campaigns. For example, we hired additional team members in our marketing outreach department which we now call strategic relationship development, bringing the total number of employees in that department to 25.5 FTEs at the end of the first quarter 2013, compared to 19.5 FTEs at the end of the prior-year period.

During the first quarter of 2013, APUS became an education partner for the National Retail Federation Foundation, which will enhance our outreach efforts to the retail sector. And the National Contract Management Association to bolster our successful outreach to government contractors. APUS also extending its leadership position in the public service sector through new relationships with the North Carolina and Rhode Island Chiefs of Police Associations to support their continuing education, leadership, and management training efforts in response to critical needs of law enforcement communities.

Our strategic relationship team also expanded an existing partnership with the Loss Prevention Foundation and established a new agreement for APUS to become an education partner to Booz Allen Hamilton, a leading consulting firm with 25,000 employees serving in US government and private sector. We increased the number of community college agreements and relationships to more than 290 community colleges, an increase of approximately 40 compared to the fourth quarter of 2012. Our affordability and focus on quality online education programs continues to make us an attractive partner to many community colleges.

While institutions struggle with complex issues related to the rising costs of higher education, our technology and other approaches enable us to remain an industry leader on matters related to affordability. We have invested heavily in innovations that support student success and streamline university operations. Some of these initiatives, such as our ePress online library solution, are yielding exceptional results both in terms of supporting student success and lowering the cost of course materials.

To date, we have developed open source materials and/or required lower-priced ebooks for a proximally two-thirds of APUS' courses, bringing our average cost of undergraduate course materials down from approximately \$62 per net course in 2011, to approximately \$48 as of March 31, 2013. We believe further improvements in our ePress online library solutions, as well as in other information services, are possible in that additional efficiencies are attainable in the future as we develop new open source content for courses, and continue to innovate and enhance our delivery platforms.



I am pleased that bad debt has continued to decrease as a percentage of revenue, after reaching a high of 5.1% in the second quarter of 2012. The year-over-year improvement and the continued reduction in bad debt may support our expected overall margin improvement in 2013. Bad debt expense declined to 4.3% of revenue, compared to 4.5% of revenue in the first quarter of 2013.

Lastly, we have made new hires that [will add to the bench strength of our executive leadership as we innovate, expand, and enter new market segments. Recently, we hired Mike Miotto as our new Senior Vice President and CIO. Mike has more than 25 years of experience as an IT leader and is responsible for leading all aspects of the university's IT department.

In addition, Rick Sunderland was hired as Senior Vice President of Finance, after having served as a consultant to APUS for over a year. Rick has over 25 years of experience in leading the financial and operations functions of large established companies as well as in building the financial operations of emerging growth companies. I am very pleased by these additions as well as with the other new hires that have joined our organization over the last few months to help us fulfill our institutional mission.

Moving over to slide number 4 and highlighting some recent academic quality initiatives. Of course, underpinning all of these efforts is our continued focus on academic quality and quality improvement. Our faculty and staff are currently adopting and mapping all APUS courses to the Lumina Foundation's Degree Qualifications Profile, or DQP, framework. This transformative and major undertaking defines student performance by degree level and sets reference points for measuring learning outcomes in all courses.

In addition, we are adapting our technology systems to optimize student and faculty access to our websites, campus, and classrooms, from various devices such as smartphones, tablets, and PCs. We believe this will further enhance student engagement and persistence.

During the quarter, APEI made a \$4 million minority investment in Fidelis Education. Fidelis is an impressive early-stage company with an innovative software platform and development that helps students, faculty, and staff to interact in meaningful ways outside the classroom. Our investment in Fidelis represents our confidence that this product can not only benefit APUS but also the millions of working adult students attending online programs. The leadership team at APUS believes in implementation of Fidelis' platform will improve persistence of service members and working adults, as well as assisting them in planning for successful career transitions.

At American Public University System, we are focused and committed to promoting teaching excellence. This year we awarded 15 faculty research grants designed to advance online higher education knowledge and practice in key discipline areas. These annual APUS grants honor the accomplishments of our faculty who demonstrate the University's commitment to delivering quality, relevant academic programs. Both internally and externally funded grants advance the knowledge base of our faculty and increase the vibrancy of the learning community by supporting some of our faculty in their areas of research interest, as well as increasing recognition to our institution.

I'm pleased to announce that we plan to begin offering several new programs, including a new BS in sports management starting in June, and a BA and MA in entrepreneurship, a bachelor of science in mathematics, and a bachelor's program in electrical engineering, all starting in September. These degrees will bring the total number of degree programs offered by APUS to 92. We plan to continue to invest in academic quality, innovation, and new business opportunities to expand access to our quality programs, diversify our student body, and fulfill our mission. The results of our approach can be seen in the success of our students, alumni, and our growing reputation.

Recently, 16 APUS students and alumni were selected as 2013 finalists to the Presidential Management Fellows Program, PMF, a prestigious two-year, paid government fellowship sponsored by the Office of Personnel Management. In addition, APUS recently became the first online school approved to be a charter member of Phi Alpha Delta, an international law fraternity. This membership is particularly important to our public policy students and those students planning to attend law school after graduation.

Moving over to slide number 5. In closing, we continue to make progress on building relationships and expanding our referral-oriented marketing approach with growing programmatic emphasis on high demand fields. Our various academic and IT initiatives help further improve academic quality and student services, as well as increase our operating efficiency. Altogether, these accomplishments made for a successful quarter with financial results that exceeded our expectations and set the stage for the continued advancement of our long-term strategy.



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

Harry Wilkins - American Public Education Inc - EVP, CFO

Thanks, Wally. Turning to slide 6, our first quarter 2013 financial highlights. American Public Education's first quarter 2013 financial results included an 11% increase in revenues to \$83.8 million, compared to \$75.8 million in the prior year. The revenue increase was primarily driven by growth in net course registrations, as well as by increased revenue associated with the implementation of a technology fee for courses beginning after September 1, 2012. Operating income for the first quarter 2013 increased 22% to approximately \$18.2 million, compared to \$14.9 million in the same period of 2012.

Instructional costs and services decreased to 33.9% of revenue in the first quarter of 2013, compared to 36.7% in the prior-year period. This decrease was primarily related to cost savings from our ePress online library initiatives and greater use of ebooks and improved utilization of full-time faculty. Full-time faculty are required to teach a certain number of courses and their salaries are generally fixed by their contracts with the University. Whereas adjunct faculty are paid variable compensation, depending on the number of net course registrations they teach.

In response to the temporary suspension of military tuition assistance, we adjusted our faculty utilization, scheduling more full-time faculty for courses starting during the period of time when TA was suspended, to better manage our instructional costs. The efficiencies gained by these adjustments may be reversed when full-time faculty members begin to meet the contractual requirements and a greater percentage of adjunct faculty are utilized for instruction later this year. However, the Company expects to continue the benefit of ePress initiatives throughout the year.

Selling and promotional expense as a percentage of revenue increased to 19.7% of revenue, compared to 19% in the prior-year period. This increase was primarily related to higher costs associated with online advertising and increased staff focus on strategic relationships. General and administrative expenses decreased as a percentage of revenue to 20.9% from 21.2% in the prior-year period, due to headcount growing slower than revenue and a slight improvement in bad debt expense. Bad debt expense as a percent of revenue was approximately 4.3% during the first quarter of 2013, compared to 4.5% in the first quarter of 2012 and 5.1% of revenue in the second quarter of 2012.

Our effective tax rate was approximately 37% in the first quarter of 2013, as a result of earning more revenue from states with lower corporate tax rates. As such, we expect our effective tax rate to be between 37% and 38% for the remainder of 2013.

For the first quarter of 2013, net income was approximately \$11.4 million or \$0.63 per diluted share, ahead of our guidance. This represents a 25% year-over-year increase in net income and a 26% increase in diluted earnings per share.

Our cash balance as of March 31, 2013, was approximately \$120.6 million or \$6.70 per diluted share. And we have no long-term debt. We continue to repurchase our shares and during the first quarter, we purchased 154,225 shares. There remained \$18 million worth of authorized availability of our stock repurchase programs as of the end of the quarter.

As previously discussed, we intend to bring our financial aid processing in-house. As a result of transition to our internal solution, we expect there to be a one-week delay in processing which could have the effect in the third quarter of 2013 of permanently deferring, or in some cases losing, course registrations by student that would otherwise have been realized. However, this initiative to automate and bring financial aid processing in-house is aimed at improving student services and bringing approximately \$120,000 per month or more of future cost savings once we implement it.

Moving to slide 7, the second quarter outlook for 2013. APEI believes net course registration growth in the second quarter was adversely impacted by the temporary suspension of Tuition Assistance programs by certain branches of the United States military. As a result of the sequestration-related events and other factors, American Public Education expects growth of net course registrations by new students in the second quarter of 2013 to decline between negative 14% and negative 10% year-over-year. And net course registrations to increase approximately 9% to 12% compared to the prior year. The Company anticipates the second quarter 2013 revenue growth will be between approximately 10% and 13%, compared to the prior-year period.



In the second quarter of 2013, the Company expects to incur approximately \$0.02 to \$0.03 per diluted share in legal and financial due diligence expenses incurred in connection with evaluating potential transactions. Under the acquisition method of accounting, in ASC 805, such expenses can no longer be capitalized but they must be expensed when they incurred.

As we have discussed previously, APEI, as part of its long-term strategy, has an interest in diversifying its business, broadening the number of degree programs offered by subsidiary institutions, and expanding into new business segments. Some of these goals may be accomplished through transactions. As such, the Company may from time to time incur legal, accounting, and other expenses as part of its due diligence activities.

Earnings per share are expected to be between \$0.53 and \$0.58 per diluted share. However, excluding the transaction in valuation related expense as I just mentioned, non-GAAP adjusted earnings per share for the second quarter are expected to be between \$0.56 and \$0.60 per diluted share representing a 10% to 17% increase year-over-year.

Now, in closing, we are very pleased with our first quarter results. The fact that we delivered several operational successes, increased operating margins, and increased net income by 25% year-over-year in such a challenging environment should not be overlooked. We accomplished this success while continuing to make investments in information technology and academic quality, as well as while making programmatic and market related adjustments to improve our overall effectiveness.

We believe our approach to growth and diversification is right on track. We plan to continue executing our strategy for expanding our presence within the military and civilian communities through even greater focus on relationships and referrals. And by making programmatic adjustments to high demand fields to further help drive growth in a difficult overall market, especially in the fields of science, technology, engineering, and math.

In this economy and regulatory environment, diversification of revenue sources and new lines of business are important to creating long-term value and stability. We plan to expand our efforts to develop new relationships with corporations, associations, community colleges, and government agencies, an approach that we think is highly effective.

While our second quarter will be impacted by the temporary suspension of TA, a factor beyond our control, we are encouraged by the resumption of the TA program, congressional support for the program, and our recent trends indicating positive year-over-year growth in net course registrations by new students using VA and TA, as well as an improvement in the enrollment of new students using FSA. Long term, we remain steadfast in our focus on quality and affordability, as well as in utilizing technology to improve student satisfaction, increase persistence, and create operational efficiencies.

Now, at this time we're happy to answer any questions. Operator, can you please open the lines for questions?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Your first question comes from the line of Paul Condra with BMO.

Paul Condra - BMO Capital Markets - Analyst

Hi, thank you. I just wanted to ask if you could give a little bit more detail on the impact of the sequester that you saw -- are seeing. Was it where you thought that would be? And then the recovery, how quickly are you able to regain ground that you lost? If you could just talk a little more about that.



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

Sure. We don't have a precise number only because of the fact that it's difficult to estimate where we might've been in the month. We know that if you take the average of January, February, and March, and look at the TA enrollments there for us. Then in the month of April, we lost a proximally 5,000 enrollments, compared to that average. We are regaining those enrollments in May, but we don't have May drops yet since this is the first week of class and we also don't have our June numbers yet.

We're hopeful that there's a chance that we can make it up, but we don't really know. The other thing that we don't know is that while the sequester was publicized on the military, it actually impacted government agencies. And we have a number of students who work for government agencies where they had a form of Tuition Assistance that was either suspended or cut off due to the sequester and that was much more difficult to track.

Paul Condra - *BMO Capital Markets - Analyst*

All right, thanks. Can we expect any kind of an incremental spend in marketing? Did you take any actions to re-educate people that money is back, you can still get this funding? I don't know if there is anything there we could expect in the second quarter, just on the cost line.

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

Well, I think when we talked last quarter and gave guidance for this quarter and said that we were realigning our marketing spend, we said that it wasn't that we were totally cutting off some of our traditional spend, but that we were putting more emphasis on personal relationships and relationship marketing, as well as more targeted interactive marketing. Our spend, I would say, while we haven't given guidance on that for the second quarter, we'll spend what we need to spend.

We did a great job of communicating when the sequester hit. We didn't get very rash. We quickly were up with a video on our website instructing students as to the alternative actions if they wanted to take them, such as VA funding and FSA. We also guided them to the specific guidance from each of the websites of the branches of the services that cut them off.

Once it resumed, we did a similar type action with video connections as well as outreach to the bases where we're allowed to offer visiting hours on the post.

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

I'd like to say also that in the quarter were 40% of our students lost funding for a certain period of time, we still were able to grow. We're projecting to grow net income by 10% to 17% year-over-year. I think that we weathered that storm fairly well.

Paul Condra - *BMO Capital Markets - Analyst*

Yes, I wanted to ask about that. You have the new course registration guidances is down, yet the revenues and earnings estimates are really staying near guidance. It's really hanging in there. Is this something that maybe we might see more of an impact in the second half of the year?

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

Well, I think from the first quarter and what we are guiding to in the second quarter is that our operating efficiencies that we talked about last year are holding true. The other thing is that we have many initiatives going on to diversify our student population, and based on the year-over-year growth in the first quarter, we still did pretty well. We're very optimistic that we've got a lot of activities going on. We can't precisely project the



impact because of what happened with the sequester, but we certainly feel comfortable that our affordability and our reputation for quality assists us with these initiatives.

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

And I think the money spending in market is more geared toward relationship marketing which is resulting in better quality of students. I think we're really seeing that. Last year, as we recall, we were experimenting more with more television, radio advertising, more national media type things. We found that the quality of the students that resulted from that, we were disappointed with.

The change in our marketing shift, I think, over the last six months is resulting in a higher quality student. While the number of new students, may not have been as great as last year, we're convinced that the quality of students is there and that's why we're having solid financial results.

Paul Condra - *BMO Capital Markets - Analyst*

That's great. Thank you very much.

Operator

And your next question comes from the line of Peter Appert with Piper Jaffray.

Peter Appert - *Piper Jaffray - Analyst*

Did the shift in the marketing spend, Wally or Harry, obviously, bumped up the selling percent of revenue this quarter. Should we think about that number continuing to edge higher on a go-forward basis?

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

Peter, we've been pretty firm over the years about talking about capping this number at 20%, and we're pretty solidly hardlined about that with our marketing department. While it did go up this quarter, I think part of the reason for the increase was just, we're working on hiring more people to do that relationship marketing while we're still keeping spend up to bring in our own self-generated internet leads.

As well as, by the way, anyone who does lead gen tell you that the cost per lead in this sector has gone up with many traditional institutions now doing lead gen for their online programs. So I think we're doing an excellent job of continuing to manage this, and our target is still to not exceed 20%.

Peter Appert - *Piper Jaffray - Analyst*

Fair enough. Harry, you said something I didn't fully understand about the shift in the financial aid processing causing a one-week blackout in terms of new student enrollments. Is that correct?

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

Yes. We're going to bring financial aid in-house. Currently, we are using third-party loan service here to process our financial aid and we're going to bring that in-house, sometime during the second quarter. When we do that, it'll have the effect of basically shutting down.



What happens is we have cut off sending students to the third-party. We have to let them process those students into the Department of Education's COD system. Then we have to get a download of that information, of the COD system, into our new system, scrub that information to make sure it's accurate, and then turn our system back on. That process will cause about a five business day delay, in processing financial aid students.

Now, we're going to let our students know about that ahead of time. It will impact both new students and continuing students. We think overall it won't matter that much. The effect of that, I've seen it before, when we've done something similar with other schools I work with, the effect of that is really a one week delay in processing Federal aid students.

Now, on the backside of that, we're going to save about \$120,000 or \$150,000 a month in costs by bringing it in-house and doing it ourselves rather than farming it out. Plus, we'll be able to control the process a lot more. There'll be a lot of cost savings on the other end. But I do think there will be like a one-time deferral of one week of financial aid registrations.

Peter Appert - Piper Jaffray - Analyst

And that is 2Q, Harry, or 3Q?

Harry Wilkins - American Public Education Inc - EVP, CFO

The impact -- we're making this change in either late May or in June. The impact will be on July registrations. The change is being made in Q2, but it will probably impact Q3 registrations.

Peter Appert - Piper Jaffray - Analyst

So a week of deferred revenue of enrollments, conceivably that could impact the fourth quarter enrollment by what the number is, 5% or 6%?

Harry Wilkins - American Public Education Inc - EVP, CFO

Not that much, I would think, maybe more like 1% or 2%. We don't know how many won't be able to register in the next month. At most, it would be about, I would think, 2% to 3% -- one week's worth of financial aid would be 2% or 3% of revenue. But we don't know how many will enroll in time to kick that up in the quarter.

Peter Appert - Piper Jaffray - Analyst

Thank you. Wally, do you have a point of view in terms of your best guess on how the military tuition aid things are going to end up, in terms of what the programs will be looking like?

Wallace Boston - American Public Education Inc - President and CEO

The only thing that I know for certain is that the Navy has issued a press release. The Navy never stopped funding and then they issued a press release that they have money through the rest of the fiscal year. Unfortunately, the Navy's one of the smaller segments of Tuition Assistance.

Most of the services, and I believe it was the Marine Corps who was the one exception, indicated that they thought they were good for the rest of the fiscal year which ends September 30. I think the Marine Corps, and I apologize that I don't have this right on the tip of my fingers, but I think they said they're watching it quarter-by-quarter and they're funding.



The other thing, though, that we know is that they had said they would look at all benefits with Tuition Assistance. We still believe that the rumors that were out there before on what they might do, such as either 75/25 or 100% undergrad and nothing for grad students, so you would use your GI Bill benefit, are still on the table. Timing, we don't know. What we also don't know is whether or not the sequester will continue, or if Congress and the White House will reach some type of a budget deal which will negate the sequester.

Peter Appert - *Piper Jaffray - Analyst*

Great. Thanks Wally.

Operator

And your next question comes from the line of Gary Bisbee with Barclays.

Zach Fadem - *Barclays Capital - Analyst*

Hi, it's Zack Fadem for Gary. You did a nice job this quarter with persistence as a result of your new initiatives. Do you expect a similar improvement next quarter? Or do you think the impact of TA will turn that number negative?

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

We haven't tried to look at that -- I think we're doing as much as anyone in higher education in general to manage persistence, particularly online adult students. We've got a significant number of initiatives. We probably collectively between those of us who actually publish academic research, we probably publish and present 6 to 10 papers a year.

We're very actively involved with the Gates-funded PAR Project. This is something that we just think is really, really important for anyone who's serious about delivering online education. We're proud of the fact that we've continued to get better numbers on persistence.

At some point, though, when you're dealing with an open enrollment adult student population, you really run up against your cap with risk factors. We'll never have the same persistence rates that elite institutions do, but we feel pretty good and we keep refining our product as well as evaluating opportunities, like this Fidelis investment that we think will make us much more special to online students than other institutions.

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

And on the course registration, I think they're solid. Our first-quarter results were solid. I think our guidance for the second quarter is pretty solid. We're forecasting for the second quarter 10% to 13% revenue growth in a quarter where we're hit negatively by that TA loss. So I think that's pretty solid results.

Zach Fadem - *Barclays Capital - Analyst*

Yes, absolutely. You mentioned you're going to continue to expand the ePress initiative. I think you said you're at 75% of all your courses on ebooks now and plan to go to 100%. What's your timeline there?

And do you expect a similar incremental cost savings impact? Would it be at the end of this year or would that be more in next year?



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

I think ultimately our real goal would be that over time, we could convert all of our resources to open resources and have zero cost. I don't think that's possible to make that happen but clearly we made some improvements. We had targets. We have targets again, stretch targets, for our academic staff to locate and find acceptable open sources as well as our ePress allows them to write electronic textbooks. We have the funding for that.

If we contribute some of those textbooks to the open resource initiative then we're allowed to access other textbooks that have been contributed. The goal is to continue to reduce the number. But I can't tell you exactly where we'll get to, as much as we feel pretty confident that we'll continue to reduce it.

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

I think the goal we established, when we found our academics two years ago to lay this out, we were spending more than \$60 per student per class in textbooks. We asked them, as a goal, to try within two years to get us down to about \$40 or less per class and we're on pace to do that.

Zach Fadem - *Barclays Capital - Analyst*

And just a final quick question. The last two quarters on your P&L, you've written down a small investment loss. I'm just curious what's going on there.

Is that that New Horizons investment that you made a few quarters ago? If so, why write down an investment loss so quickly?

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

We're accounting for that in the equity methods. 20% of their gain or loss is flow through to us on our income statement. So it's not really a write-down, as much as it's us recognizing our share of their income or loss.

Now, they have positive cash flow but because of the way that the tax provision works, whether tax assets are higher than their book assets, and they're writing down a lot of tax and goodwill, they have this unusual tax effect. But they have positive cash flow, some book losses, which should turn around in the second half of this year. The losses aren't that significant.

Zach Fadem - *Barclays Capital - Analyst*

But this item will continue.

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

The line item will continue. It should be positive by the end of the year.

Zach Fadem - *Barclays Capital - Analyst*

Thank you guys.

Operator

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



Corey Greendale - *First Analysis Securities - Analyst*

Good afternoon.

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

Hi, Corey.

Corey Greendale - *First Analysis Securities - Analyst*

A few questions for you. First of all, looking at the guidance, it suggests that total registration growth will accelerate in Q2 which is a little counterintuitive, given that you have a few quarters of negative new student registrations with the sequester impact. Can you explain that drives of that acceleration?

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

Sure. We announce that we were having a focus on marketing, bringing in better students. We have had all of these retention and persisted initiatives. That continues to be a focus of ours and we're confident enough that we believe that we'll see continued top line growth in the second quarter because of those initiatives.

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

You really don't need as many new students if they persist and take more classes. One of the things that we're concentrating also on is the increase the number of classes taken by our good students and try to get new students. I think that also helps.

When you have a good student who takes eight courses a year, replacing a couple of bad students who were taking one or two courses a year, it does impact net registrations. Even though the actual number of new students may not be as high, you can increase your enrollment that way of courses taken.

Corey Greendale - *First Analysis Securities - Analyst*

Okay. In terms of increasing the quality of students, is that primarily a function of your recruiting methodology? Or are you actually implementing gating factors that student needs to meet in order to enroll?

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

We've actually not implemented any gating factors across the board. We do have some in some of our specialty accredited degrees where they have minimum standards and requirements. Naturally, when we launch our BS EE this fall, we'll have certain requirements for students. They'll have to have had calculus, for example.

But we do continue to look at the source of students and how target our marketing. We know that certain sources are better than others. We'll continue to evaluate.

We've had a mission, from our founder, that we'd be an open enrollment institution. We're not ready to call that off or anything. But we certainly have really focused much more on trying to find better sources, than just relying on the market to provides the good sources coming to us.

Corey Greendale - *First Analysis Securities - Analyst*

Okay. In turn on that topic, the students from the cash pay and other sources, that was down about 7% year-over-year. Given that you're doing more of a relationship driven marketing, one would think would help drive that in a positive direction. Can you speak to why that was down? And what traction are you seeing so far through the New Horizons relationship?

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

I think it's still too soon for the New Horizons relationship. It is complicated because in addition to working with corporate, we have to work with a lot of franchisees globally and domestically. The bigger issue with the cash is that we grew VA at 33%. A year ago, I think the number was 92%. VA grew at a pretty high rate.

Our FSA grew at a double-digit rate and our TA actually grew. When you have those numbers growing, cash -- I don't have the exact number -- but I think it was probably more flat from a cash perspective than it was from a growth perspective.

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

I think that it's just a factor of the economy, too, that even though people have funding, we're seeing more students TA apply for FSA funds. We're seeing more people with corporate sponsors apply for FSA funds.

Remember, a lot of our corporate sponsors require the students to pay in advance and if they get a certain grade, the corporation will reimburse them. But a lot of people are relying on Federal funds for that financing source because it's just the way the economy is going right now, people don't want to spend cash it seems like. They'll take the cheap source of funding in lieu of laying out cash.

Corey Greendale - *First Analysis Securities - Analyst*

That's a good point. Just one last quick one. Were there any transaction or other kind of unusual costs in G&A in Q1? Or is the \$17.5 million a good run rate?

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

There were some transactional costs in Q1, as there were in the fourth quarter of last year. But we didn't think they were significant enough to break out.

Corey Greendale - *First Analysis Securities - Analyst*

So \$17.5 million is probably a good run rate?

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

Yes.

Corey Greendale - *First Analysis Securities - Analyst*

Thank you.

Operator

And your next question comes from the line of Jason Anderson with Stifel.

Jason Anderson - Stifel Nicolaus - Analyst

Good evening, guys. You commented on 2Q, I think, seeing the recent trends being back up on new registrations. Can we talk a little more about that? Could we infer that that means in the second half there's some pretty good new registration growth, that we'll get back to that?

Harry Wilkins - American Public Education Inc - EVP, CFO

Yes. We're seeing the trends are better. I guess we had a trend of negative growth for a while. We're starting to see some better trends now. Some of that was mitigated by the TA situation.

I think that what we're seeing is a light at the end of the tunnel there. We're not projecting anything beyond the second quarter at this point but we do think that, overall, our marketing -- our relationship marketing, efforts are starting to pay off. And we're seeing a return to quality of students and we're seeing a light at the end of the tunnel, as far as growing these students goes.

Jason Anderson - Stifel Nicolaus - Analyst

Thanks for that. In regards to the persistence that everyone's been talking about here, from the way we can look at it externally here, your guidance would suggest persistence being up several hundred basis points. Is that something we should use as a run rate the rest of the year?

Harry Wilkins - American Public Education Inc - EVP, CFO

Again, we're really out of the business of giving guidance beyond the second quarter. We're giving guidance one quarter at a time. You can tell from the results that we're doing a better job of attracting quality students. We don't see anything that's going to change that, but we're not giving guidance beyond the second quarter.

Wallace Boston - American Public Education Inc - President and CEO

Right, but we continue to focus on initiatives that are designed to improve persistence.

Jason Anderson - Stifel Nicolaus - Analyst

Great. Thanks for the color. Just the last one.

How's the progress going with expanding corporate relationships? Could we get a number on that? I'm not sure if you commented on that in a while. Also, how is international going, that initiative outside of the New Horizons?

Wallace Boston - American Public Education Inc - President and CEO

We brought some work -- In terms of numbers, I don't know the exact percentage, but we have an increased number in international students. We also increased the number of people in our strategic relationship department. We talked about that in the script. We are up to 25.5 people there versus 19.5 a year ago.

We outlined some new relationships we had with corporations and associations that were signed in the first quarter. They haven't borne fruit yet, but we're very comfortable that we'll get some students out of that. We also outlined how successful we've been adding 40 community college relationships in the quarter as well.

We think that our outreach relationships are working well, and we're going to continue to focus on identifying opportunities and putting people in the field to work on increasing those. Because we really think they're a source of better students than the traditional media marketing.

Jason Anderson - *Stifel Nicolaus - Analyst*

Great. Thanks for the color.

Operator

And your next question comes from the line of Trace Urdan with Wells Fargo Securities.

Trace Urdan - *Wells Fargo Securities, LLC - Analyst*

Hi, good afternoon. Wally, you mentioned a bunch of new programs that you're prepared to roll out. I was struck by the quantity of them and other HLC-accredited institutions are telling us about a real slowdown in their ability to get HLC to approve new programs. I'm wondering how long these have been in the pipeline and whether you're seeing that as well, or having a different experience?

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

I think everything is dependent on the type of program you have and also how long you've been accredited, at least in the HLC -- how long you been accredited. And how comfortable they are in with whether that program is totally new from what you've offered in the past, or it's fairly similar. We typically spend more than a year developing our programs. In general, the BS EE we spent over three years because we had to find what we thought was an affordable alternative to electronic labs, for the circuits courses that are required in the program.

I don't think that I could say that approvals have slowed or that approvals have increased. I think there's a process that they have. I think they're following those processes.

Are the processes tighter over the last three years than they were five years ago? Maybe. But I feel comfortable with the process and I feel very comfortable with our ability to work with the HLC in getting degree approvals, when we're ready to submit them for approval.

Trace Urdan - *Wells Fargo Securities, LLC - Analyst*

Fair enough. I wanted to see if we could get a little more color on the Fidelis investment. Are you a large source of leads for them? Or does their business not work that way?

Maybe you can talk about what you see coming from that relationship. Does this deepen your involvement with them, the fact that you're investing in them? Do you guys have an option to buy somewhere down the road as a result of this investment? What do you see as the drivers of growth in what they do?

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

Sure. We've -- I've known Gunnar for close to three years. I met him for the first time out at the ASU Ed Innovation conference. We have been talking, and really I think if you talk to him, and I would advise you to talk to him, just to get it from his perspective. We liked his platform but we thought that a lot of time would have to be pursued to find individual students to be attracted to the platform.

In our case, we said, what about letting us license the platform for use as an institution and look at your product that way? I think it's caused him to shift that at least in phase one of development, it's actually a better idea to find institutions that are intrigued about the platform and the concept. And it is a rather innovative platform that allows students to be advised and counseled on both their degree completion, as well as goals for careers and transitioning from work and a degree, to a career.

That's the approach that he's taken and that we're taking in using the platform. There's really no referral of us to leads. I think that piece of his company strategy has shifted for now. He's much more product focused so I think with us piloting and then ultimately converting to the entire student population, includes military as well as civilians, that he'll probably have other institutions interested, if not interested already.

We made this investment as a minority investor because we actually believe that the investment itself has potential to help influence the progression and successful completion of online students in a lot of institutions. We just felt that it was much better for us to be a minority investor in that. We'll see. I guess if the opportunity presents itself sometime and it's really doing well, maybe we would own that technology platform. But right now, we think it's great to be in the position that we're in, as a minority investor.

Trace Urdan - *Wells Fargo Securities, LLC - Analyst*

Does it move the needle from a marketing standpoint? Does it move the needle in terms of how the base education officers think about what you guys are bringing to the table?

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

I think it moves it from a persistence perspective, once we are fully implemented, Trace. It may move it from a marketing perspective, particularly, if we're the first mover using it. But we'll see.

I think it's too soon to call that. But we believe from all of the interaction we've had with Gunnar and his team that it's going to be another ability of us to improve persistence. Usually when you improve persistence, you get more referrals from your students to prospective students, so perhaps it'll help with the marketing as well. It's too soon to call that.

Trace Urdan - *Wells Fargo Securities, LLC - Analyst*

And then, last question for Harry. Harry, I hear you saying that the transition in terms of what you're spending your marketing dollars on won't cause the total amount to go up or down necessarily. But I'm wondering -- or it seems I guess to have the effect of going from what we would think of as a more variable cost, to maybe more of a fixed cost. I wonder if you could just speak to that element of it.

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

I think that's true. In many cases, we are replacing newspaper and TV advertising with people, doing relationship building. However, we do monitor the costs very closely. We really have a stated goal which we've managed to live with.

We said it when we went public in 2007. We still say the same thing. We don't want marketing costs to get above 20% of revenue.

We certainly have budgeted that way. We continue to manage that way and I think that's our story and we're sticking with it.



Trace Urdan - Wells Fargo Securities, LLC - Analyst

Okay. Sounds good. Thank you.

Operator

And your next question comes from the line of Adrienne Colby with Deutsche Bank.

Adrienne Colby - Deutsche Bank - Analyst

Hi, thanks for taking my question. I was wondering if you could talk a little bit about the expected charge that you're going to be taking in the second quarter, related to legal and financial due diligence, what that's related to?

Wallace Boston - American Public Education Inc - President and CEO

Well, I think it's significant in that year-over-year, it was higher than what it was in the second quarter a year ago. Also, the SEC came out with something that says you can no longer capitalize those costs.

If we had something to announce, we'd announce it, obviously. We continue to look at opportunities that we think are very synergistic for APEI, as well as APUS. In the second quarter, we have a number that we thought was important to point out so that we didn't cloud it and people think that we were achieving our operating efficiencies, but that we had a notable difference.

Adrienne Colby - Deutsche Bank - Analyst

Okay. So you can't comment if you're looking at something in particular, or someone's looking at you, or any more color on that?

Wallace Boston - American Public Education Inc - President and CEO

Sorry, I can't.

Adrienne Colby - Deutsche Bank - Analyst

Okay. I was wondering if you comment a little more on the trends you're seeing in FSA or Title IV in your registration growth. I know that that's been a pretty big drag, at least in the fourth quarter and the first quarter. When we look at your guidance for second quarter, we can assume that's either flat or there is some positive offsets of the lost Tuition Assistance enrollment, or new registrations?

Harry Wilkins - American Public Education Inc - EVP, CFO

Yes. I think if you look at slide 3 in our first quarter highlights, we were showing FSA growth was about 11% year-over-year. I think our guidance gives credence to the fact that with TA being so negatively impacted in the second quarter, that our FSA student numbers are doing just fine.

Adrienne Colby - Deutsche Bank - Analyst

Okay. You saw an increase in the number of relationships you have with community colleges, a pretty dramatic increase actually, quarter-over-quarter. It sounds like from comments from peers that that's becoming a very attractive target to a lot of four-year schools. Just wondering if you comment



on what points about APEI are really resonating there, if it's something beyond just the IC costs, what quality metrics they ask you for, what other factors they're interested in.

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

It varied. There are community colleges that seek us out specifically for our affordability. There are community colleges that seek us out because every month we offer 2,000 unique courses and 80 some degree programs and that availability is much more frequent than their availability.

We also offer Master's degree programs that, in some cases, are very relevant to their faculty. We, in addition, provide a block transfer capability for them in specific degrees, in some cases, even their own state four-year institutions can't provide.

It's across the board. I would say that we've got a very well-seasoned team that does a good job of listening. We don't get super aggressive. We're not trying to find out names and call people, cold call them.

Instead, we simply ask that we get invited to the transfer fairs that they have on campus. Some have them as often as six times a year. Generally, it's about four times a year and we send our outreach people to those transfer fairs. And because of the either MOU or articulation agreement that we have, we're finding some success.

I think the big thing in certain states that have had to increase their four-year tuition is we're finding that our affordability resonates with a decent part of the population. And when you look at other for-profits, in many cases, we're much more affordable than they are.

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

We really believe there's a need for a national affordable public university. And we really think American Public University can become the university of choice for people who are seeking online education and affordability.

Plus, the now 92 degree programs -- the soon to be 92 degree programs, we can pretty much meet the needs of just about any community college graduate out there, unlike other universities. So I think that's what we have to offer. That's what we talk to them about, and that's what they buy into.

Adrienne Colby - *Deutsche Bank - Analyst*

Great. And just a follow-up, is it fair to assume that we might see more of an impact on the new course registrations in the fall term, that most of those students tend to follow a typical academic calendar, finishing in the summer and then enrolling in the fall?

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

That's true. Although, if you look at community college populations, they're pretty diverse. They have a traditional set that follows the September enrollment and then they have working adults who take courses here and there to fill in. Our expectation is that as we sign agreements, we'll probably find the ones who are graduating and want the block transfer will graduate in May or June. And will look to start in the fall.

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

I think we've consistently said that as we become more civilian, we expect to become more seasonal. I think that will be the case.



Adrienne Colby - *Deutsche Bank - Analyst*

Thank you.

Operator

At this time there are no further questions in queue. I would now like to hand the call back over to Mr. Symanoskie for closing remarks.

Chris Symanoskie - *American Public Education Inc - Associate VP IR*

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

Operator

Ladies and gentlemen, that does conclude today's conference. Thank you for your participation. You may now disconnect. Have a wonderful day.

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