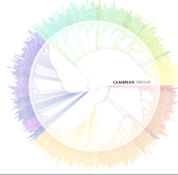
CAMBRIAN GROUP

Apollo Group

strategic report

CAMBRIAN GROUP



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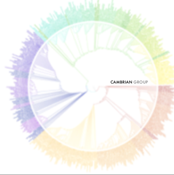

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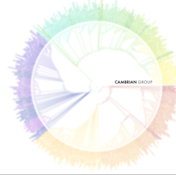

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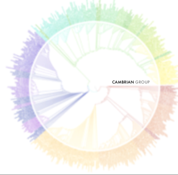

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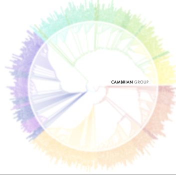
EXECUTIVE SUMMARY

Following a tumultuous earnings period at the end of 2010, Apollo Group management retained the Cambrian Group to provide a detailed strategic report and recommendations to the executive committee. The Apollo Group in an industry leader in the proprietary educational services industry with large domestic and growing international product portfolios. While the company operates through four reportable segments, the two principal segments include: University of Phoenix and Apollo Global. The company's unique governance structure and business model have given the firm a competitive advantage in the industry and when combined with extensive technological and data management systems have made Apollo the industry bellwether. From its initial public offering in 1996, Apollo has grown to $4.93 billion in sales and a market capitalization of $5.96 billion. Despite these accomplishments, the company faces a myriad of potential issues including declining profitability, a negative public perception, a concentrated revenue base and a very public series of government inquiries. These recent developments have strained Apollo Group's management as the firm seeks to remedy these weaknesses while continuing international expansion plans and diversifying away from its core brand University of Phoenix.

The Cambrian Group strategic analysis will analyze the current corporate strategy of Apollo Group executive committee and provide strategic recommendations. The report includes the following sections: Company Background, Competitive Analysis, Financial Analysis, SWOT Analysis, and Strategic Recommendations.

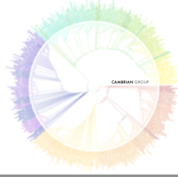
The Cambrian Group recommends that Apollo Group focus on the following strategies:

- Reduction of bad debt exposure through an increased focus on and implementation of mandatory University Orientation Program
  - Piloted during 2009 and fully implemented in November 2010, the program requires under-qualified students to undergo three weeks of education surrounding the financial costs and time commitments of higher education.

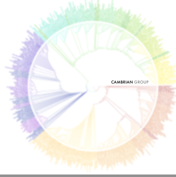


- By enrolling the students most likely to complete coursework and repay student loans, the Apollo Group will also reduce per-student costs and increase profitability
- Addresses increased government scrutiny surrounding Title IV student aid programs

- A renewed focus on corporate relationships
  - Corporate training relationship benefit Apollo Group by diversifying revenue streams and providing increased recognition of degrees and certification
  - Potentially provide a mechanism for international expansion
- Maximization of University of Phoenix brand name
  - As an industry leader, the Apollo Group must continue to cultivate a strong reputation through quality education offerings
  - Indirectly reduces regulatory pressures through enhanced student placement and financial outcomes.



PART I
INTRODUCTION

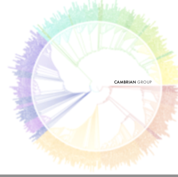


COMPANY OVERVIEW

Industry History

The higher education industry has long been dominated by private and public non-profit organizations. Many have argued that dominance of the industry was, and is, necessitated by the good itself. Since the market consumer cannot easily view the benefits of higher education until well after the education experience has ended, a profit motive leaves open the possibility that suppliers may take advantage of students. Additionally, the benefits of higher education may be greater than the individual student's experience leading to the notion of higher education as a public good. While it is clear that and educated population is clearly required for democracy to succeed, there may also be diminishing marginal returns to the government's investment. A population should be able to read and write but purely vocational training is not necessarily a requirement for citizenship but a factor in increasing economic output.[i]

To that end, it is important to note that higher education encompasses a broad range of programs. Contrary to the popular belief that private for-profit/proprietary education is a recent phenomenon, they have existed in the United States since the nineteenth century. While these institutions did not have degree-granting powers, they provided vocational training such as typing and the use of stenographic machines.[ii] If not for the release of Flexner Report in 1910, which called for heavy regulation of for-profit educators, the higher learning industry in the United States would look much different than the system of institutions we observe today. In fact, there is one major similarity between the current explosion of for-profit schooling and the previous rise that occurred around the turn of century: both periods experienced the proliferation of technology and knowledge-based occupations. A 2010 study by the U.S. Department of Education's National Center for Education Statistics (NCES) estimated the industry to be worth $432 billion in 2008. It is within this context that institutions such as the Apollo Group, Career Education Corporation and Education Management Corporation rose to prominence in the late 1980s and early 1990s.

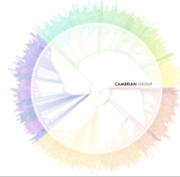


Regulatory Environment

As mentioned above, the for-profit education industry is highly regulated in the United States. While the Cambrian Group does not wish to belabor this issue it will be ever-present in our analysis of the Apollo Group. Accordingly, we will provide a brief explanation of the three major regulatory constraints, as they currently exist. These three important regulatory areas are: accreditation, the 90/10 Rule and student loan default rates. To foreshadow there importance, approximately 80 percent of the Apollo Group total revenues came from federal financial aid or the government.

The first hurdle that a for-profit education must pass is that of accreditation. Under the Higher Education Act of 1965 (HEA), an institution may be recognized directly through the Department of Education (DOE), state higher education regulatory bodies or accrediting agencies recognized by the DOE.[iii] Accreditation is necessary for two reasons. First, it signals to students that the institution has passed a threshold on the quality of education provided thereby addressing on the market issues discussed above. Second, accreditation is a requirement for eligibility for federally sponsored financial aid under Title IV programs. Title IV programs include most federal student aid such as Pell Grants. The Apollo Group and its main revenue-generating business, University of Phoenix, are regionally accredited. While there are significant burdens associated with this regulatory constraint, the current industry structure necessitates compliance.

The second and third regulatory requirements are both related to revenue derived from government financial aid programs. The 90/10 Rule states that for-profit institutions will be ineligible to participate in Title IV programs if for any two consecutive fiscal years it derives more than 90 percent of it cash basis revenue from Title IV programs. The Apollo Group has acknowledged that should any of its programs become ineligible that they would no longer be profitable under their current business model. The third and final regulatory requirement is student loan default rates. Under the HEA, an institution will lose it eligibility to participate in some or all Title IV programs if its student loan cohort default rate equals or exceeds



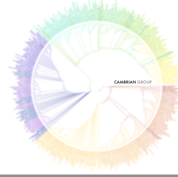
25% for three consecutive years or 40% for any given year.[iv] As the Cambrian Group will show below, the associated lag between the funding and default of student loans is significantly impacting the Apollo Group and top-line and bottom-line revenue figures. With the important current regulatory rules having been discussed, we can now move to a discussion of the Apollo Group.

Company History

Sperling's Radical Idea

In 1973, John Sperling founded Apollo Group, Inc. in response to what he saw as changing post-secondary education demographics. Sperling, a Cambridge-educated economist and professor, believed that the gradual movement of the United States' economy away from manufacturing and to service would lead to much higher numbers of working adults seeking post-secondary education. He hypothesized that traditional schools catering to a much younger student population would largely be unable to handle to handle the educational demand of working adults. In what would become known as for-profit schools or proprietary schools, Sperling and Apollo sought to provide private education services that would cater to "working learners" and other non-traditional student groups. In 1976, Apollo entered the for-profit education market and founded the University of Phoenix. The University of Phoenix provides a teaching model and curriculum that are consistent with the needs of working adults allowing them to enroll while continuing there normal work duties.

While many have focused on Apollo Group's for-profit motivations, the company has become a significant source of post-secondary education in the United States with an enrollment of over 470,000 students at the end of fiscal year 2010. The theoretical underpinnings of the argument for private educational institutions are somewhat simple to state but difficult to measure in practice. Apollo and her competitors seek to provide education with the accountability, operational efficiency, and cost and time benefits that traditional schools do not possess. Whether or not the private education model provides these benefits is still an open question that will be addressed in the competitive analysis section below.



Apollo's Rapid Growth

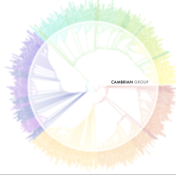
By the late 1980's, Apollo, through the University of Phoenix Online was pioneering new forms of education. In the past, for-profit education institutions had provided working students with access to classes scheduled after normal working hours, along with academic support facilities catered to their specific needs. These support facilities included bookstores with later hours and university offices open at night. While these facilities helped adult students complete their degrees faster, they were still far behind their younger traditional student counterparts.

One of the chief constraints opposing the working learner is available amount of time in the day. By still having to drive to a satellite campus and attend class, the working adult was losing valuable work and study time. With the invention and proliferation of the internet, the for-profit educational model could be delivered to the student's home thereby eliminating most of the need for travel. By targeting students that may not have had past access to continuing education, Apollo Group was able to steadily grow its business through internet access and more traditional satellite campus programs. Apollo Group's continued growth through the implementation of internet-based learning models has also resulted in significant economies of scale and scope. After developing various portals, Apollo has strived to maximize the value of these networking economies of scale by continuing to fill out the market space by broadening its product portfolio.

On December 16, 1994, John Sperling's Apollo Group became the first major for-profit educational institution to have an initial public offering on a major United States stock exchange when it was listed on the NASDAQ Exchange under the ticker symbol APOL.

Apollo Today

Today, Apollo Group is one of world's the largest private education providers with a market capitalization of $6.10 billion and annual revenues approaching $5 billion. Accounting for approximately 91% of Apollo



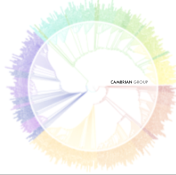
Group's net revenue, The University of Phoenix had a total enrollment of 470,800 for the quarter ending August 31, 2010, making it the nation's largest educational institution. Through Apollo's subsidiaries, the company provides educational programs at the undergraduate, master's and doctoral levels. The four principal institutions that are wholly owned include:

- The University of Phoenix, Inc.;
- Institute for Professional Development;
- The College for Financial Planning Institutes Corporation; and
- Meritus University, Inc.

In October 2007, Apollo formed a joint venture with the Carlyle Group called Apollo Global, Inc. The partnership was formed with an emphasis on expanding educational services internationally but has also undertaken some domestic projects. Apollo Group currently owns an 85.6% interest in Apollo Global with the remaining 14.4% being held by the Carlyle Group. Of the approximately $555.3 million allocated to the joint venture, some $475.3 million has been allocated by the Apollo Group representing a measured but significant investment in international education.

In July 2010, the Department of Education proposed significant changes to a number of policies that govern an institution's eligibility for Title IV student loans. The proposed changes reflect a growing concern amongst those in Congress that for-profit educators have been attracting students that are unlikely to repay their government loans thereby saddling Title IV with increased loan defaults. The proposed rule change are significant in that they require repayment rates of 45 percent and debt service-to-income ratios of less than 8 percent. These rules have the effect of making sure that students participating in programs are benefiting from "gainful employment" and have the necessary means to pay back their government held debt.[v]

In addition to the DOE's July rule-change proposal, in August 2010 the General Accountability Office (GAO) released a report condemning the recruiting practices of most major for-profit educational institutions. Since 91% of Apollo Group's net revenues originate domestically through the University of Phoenix, compliance under HEA and related government

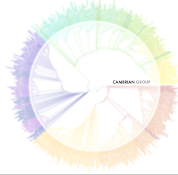


programs is crucial to the company's success. In fact, 88% of the University of Phoenix revenues were derived from federal programs associated with Title IV financial aid.[vi] In response to this report, a United State's Senate Committee on Health, Education, Labor and Pensions requested detailed information on the recruitment practices of various Apollo Group subsidiaries.

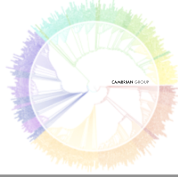
The report by the GAO led the management team to revaluate the recruitment policies and subsequently eliminate the use of third-party recruiters by bringing recruitment efforts in-house. Additionally, the management team eliminated final enrollment results from the internal recruiter compensation formula to better comply with Title IV regulations. Following the corporate restructuring, Apollo Group has experience a significant enrollment drop of 9.8% for the fourth quarter of fiscal year 2010 compared to the fourth quarter of 2009. The company's ability to continually adapt to new regulatory pressures is an absolute key to its long-term viability as such a large portion of revenue originates from government-sponsored loan programs and underscores one of the potential difficulties of competing in such a highly regulated industry.

Apollo's Struggles Continue

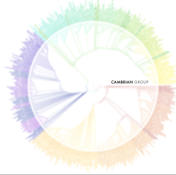
The Apollo Group reported a loss in its second fiscal quarter as its international operations continued to underperform its expectations. For the period ended February 28, Apollo reported a loss of $64 million, or 45 cents per share. This was a dramatic turn from a year ago when the firm recorded a profit of $93 million or 60 cents per share.[vii] The earnings release also revealed that Apollo wrote down as asset impairment charge of $176 million as its BPP unit continued to suffer from poor economic conditions in Britain. Excluding the impairment charge, revenue from continuing operations dipped fell one cent to 83 cents as enrollment continues to decline. Degreed enrollments fell another 12 percent to 405,300 according to the Company's quarterly filing.[viii] "We expect declines in new enrollments that we're experiencing in 2011 to be felt more in our financial results in 2012," co-CEO Chas Edelstein said on the Company's quarterly earnings call.[ix] In another potentially devastating blow, Congress detailed budget cuts in its 2011 budget compromise. Congressional



negotiators agreed with the Obama administrations to curtail federal financing for for-profit educators. As the article notes, "The Obama administration has been trying to make sure that students who take out loans are able to get the jobs for which they train." [x]



PART II
ANALYSIS



COMPETITIVE ANALYSIS

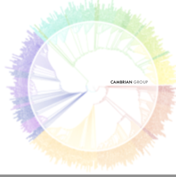
Force	Strength
Internal Rivalry	High
Entry & Exit	Low
Substitutes & Complements	Low/Medium
Supplier Power	Medium
Buyer Power	Low

Internal Rivalry

Apollo Group, Inc. is part of the non-traditional education sector, which is a significant and growing component of the postsecondary degree-granting education industry. Within the sector, the Company competes with other for-profit education companies. University of Phoenix and other Apollo Group companies offer flexible schedules to meet the time constraints of their students, who they describe as "working learners".

Apollo Group is the largest for-profit education company in the industry, enrolling approximately 400,000 students and operating over 472 physical campuses worldwide in addition to its online "campus". As a result of its size, rapid growth and strong brand name, Apollo Group competes well within the for-profit education space. It is currently growing at a rate of 7 to 9 campuses per year, leading ahead of its peers. Some argue that since the industry is expanding so rapidly, for-profit education companies compete more for new market share than each other's. Its main competitors are Career Education Corporation, Corinthian Colleges, Strayer Education, and Sylvan Learning Systems. The Company competes with these firms in a variety of ways, including:

- Active and relevant curriculum development that considers the needs of employers
- The ability to provide flexible and convenient access to programs and classes
- Reliable products and services



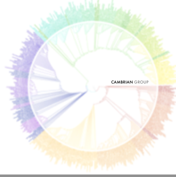
- Breadth of programs offered
- The time necessary to earn a degree
- Qualified and experienced faculty
- Reputation of the institution and its programs
- The variety of geographic locations of campuses
- Cost of program[xi]

The Company also competes with a variety of business and information technology providers in offering non-degree programs. Many of these competitors have significantly more market share given their geographical regions and longer-term relationships with key employers of potential students. Last, Apollo Group competes with community colleges and non-profit schools that cater toward non-traditional students.

Entry and Exit

The main barrier to entry in the for-profit education space is that each school must be accredited by the U.S. Department of Education. Often the accreditation process is timely and costly because it requires the participating institution to complete the requisite paperwork and then wait for the peer review process to be complete. This, coupled with the fact that there are many existing for-profit educational companies with strong reputations, makes it fairly difficult for new entrants to gain market share. However, there are fewer barriers to entry in international markets, especially in developing countries with fewer regulators. There are particularly high margins for English language programs in Asia and Latin America.

Obtaining government financing is another roadblock for many potential for-profit education companies. In order to participate in Title IV programs, an institution must be accredited by an accrediting agency certified as eligible by the Department of Education (DOE). The DOE only certifies institutions to participate in Title IV programs after it demonstrates compliance with the provisions of the Higher Education Act and the DOE's extensive regulations regarding institutional eligibility. If a potential company fails to fulfill these requirements, it will not be able to compete with schools whose students are eligible for federal loans and financial aid.

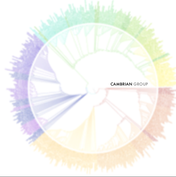


Moreover, Congress reviews and reauthorizes the Higher Education Act every six years, a process that changes the face of the legislation, which can have significant positive or negative effects on entry into the for-profit education industry.

Substitutes & Complements

There exists serious debate over whether for-profit education companies like Apollo Group offer better products and services to students than non-profit community colleges and other schools. Talking heads wishing to argue that non-profit colleges and universities, including community colleges, offer better educational programs to their students are largely missing the point. While there are countless examples of traditional schools providing benefits—monetary and non-monetary—for their graduated students, for-profit educational institutions also provide these educational benefits. The main point to be argued is the extent that for-profit and traditional education institutions compete for the same target students. While traditional schools, targeting a student age 18-22 in the United States, offer many interesting opportunities, non-traditional "working leaners" do not benefit from the same type of programs. For instance, California community colleges established a partnership with the University of California educational system whereby students who earn a certain grade point average are guaranteed admission to a four-year university in the U.C. system after obtaining their associate's degree. Apollo Group and its competitors do not offer such benefits. However, most students who complete degree programs with Apollo Group do not have schedules that would allow them to attend a four-year college in the future, or even community college classes during the workday. Additionally, non-traditional students have a much higher likelihood of requiring shorter-term monetary benefits as they may have more dependents. This debate suggests that that there are valid reasons to enroll at an Apollo Group school over a non-profit community college, or vice-versa.

Moving past the ongoing debate surrounding the degree to which non-profit and for-profit schools are substitutes, the Cambrian Group believes that these institutions are direct complements. Traditional schools have traditionally been known to follow a more traditional research-intensive

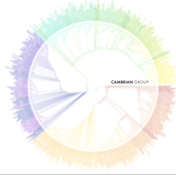


learning model. Frankly, these institutions are expensive to operate are not characterized by their economies of scale and scope like for-profit institutions as they required increasingly specialized and divided sources of labor. The Cambrian Group believes that the entrance of for-profit educators that target different a slightly different student market is strong complement to this the research model. At base, both models serve to educate different portions of the workforce and provided that graduates are able to find a meaningful work opportunity afterwards, society is better off with both forms of educators.

Supplier Power

A distinctive feature of the University of Phoenix educational model is heavy reliance on part-time practitioner faculty. Faculty must have a master's or doctoral degree in the field of specialty and at least five years of experience although the average is slightly over 16 years.[xii] Despite a perceived lack of professionalism associated with part-time nature of the faculty, after completing mandatory up to 10 mandatory workshops are pre-service faculty considered for employment. Ultimately only 30 to 40 percent of applicants are accepted.[xiii] As of August 31, 2010, Apollo Group employed over 35,000 faculty members through its different business segments.[xiv] In a departure from the traditional education model, approximately 1,300 employees serve as faculty members and also serve administrative roles. These policies are the basic explanation for Apollo Group's profitability over the past twenty years. By controlling faculty costs and other supplier power, Apollo has reaped significant benefits from economies scale as the company has continued to grow.

At the Company's University of Phoenix, a small group of faculty members standardize the school's curriculum and then distribute online courseware through the University. This is much cheaper than the traditional educational model of paying instructors to develop individual lesson plans under a common curriculum. Since the vast majority of faculty members are fully employed elsewhere and only teach in evenings, Apollo Group has been able to exploit the non-monetary benefits involved with faculty positions. The pay of between $1,000 and $1,600 for a five to six week class is hardly sufficient to entice faculty members although the hourly rate is



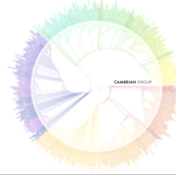
not bad. Alluded to above, Apollo Group faculty typically teach between 20 and 24 hours per course, as compared to the 40 hour industry standard, because curricula are designed for students to spend many hours on group projects without faculty supervision. This provision allows for further cost spreading and allows Apollo Group to turn a potential profitability inhibitor into a competitive advantage.

In order to mitigate costs, University of Phoenix and other Apollo Group schools seek to reduce their reliance on textbooks. Instead, the Company contracts authors and experts to create course materials, collectively called rEsources, which perfectly match curricula. This enables the Company to bypass negotiations with publishers. Similarly, rEsources enable Apollo Group to avoid working with software manufacturers to create learning modules and online classroom forums.

With over 472 facilities as of August 2010, Apollo Group is vulnerable to swings in the commercial real estate market. It leases 87% of the approximately 9.6 million square feet of facilities that is uses, owning the remaining 13%. It is interesting to note that approximately 93 percent of the property occupied in the United States is leased while the vast majority of international property is owned outright. Since many of the lease agreements include rent escalation clauses, if commercial real estate prices climb in the future, the Company will have to pay greater rent expenses, decreasing its bottom line. Similarly, if real estate prices fall, the value of the properties that the Company owns will decrease, but the corresponding drop in rent expenses will more than offset the effect.

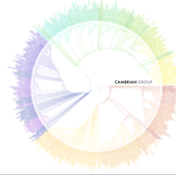
Buyer Power

The large pool of potential buyers (students) restricts the power than any one of them could exert against Apollo Group. The Cambrian Group also believes that the countercyclical nature of the education industry also reduces buyer power. In times of economic distress and uncertainty, workers suffering from structural unemployment due to mismatch of labor supply and demand must retrain to find employment. As noted above, the continual shift to high value-added and knowledge-based manufacturing and service sectors has been a driving force of unemployment in the United



States over the past number of years. Theoretical work discussed in the strategic review section suggests that students, as a group represented through a reputational equilibrium, may be able to enforce some degree of buyer power. However, the Cambrian Group believes that interests of students and Apollo are aligned over the long term.

One reason for this belief is the price point of Apollo's products. Since tuition for Apollo Group schools is higher than that of a community college, the Company must demonstrate the superiority of its product. It addresses this by marketing its employment statistics, and showing that average salaries of its graduates are, on average, higher than those who graduated from a non-profit institution like a community college. Many analysts believe that Apollo's continued ability to prove that it education services result in an "income premium" is critical to the continued success of the company.[xv] Similarly, Apollo Group releases statistics showing that their students end up working in their fields of study, suggesting that they enjoy a measure of job satisfaction. Apollo Group also engages in print and television advertising, something that its non-profit counterparts cannot afford to do. Consequently, target students are more aware of educational opportunities at Apollo Group and other for-profit institutions than at non-profit institutions.

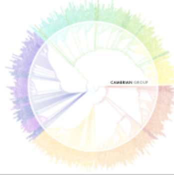


FINANCIAL ANALYSIS

Overview

As the largest for-profit educational institution in the United States, Apollo Group has maintained a positive profit for the past five years. Given the higher default rates and bad debt expenses for associate degree programs, Apollo Group has adopted a strategy to focus more on advanced degrees students and on international expansion. Their expansion strategy has not been very fruitful. Due to the global financial downturn, Apollo has incurred several impairment charges for its previous acquisitions in 2010. Their acquisition of Insight Schools in 2007 led to a $9.4 million impairment charge. They recorded an $8.7 million impairment charge for their acquisition of ULA, an accredited private university based in Mexico City. In the fourth quarter of 2010, they recorded impairment charges of $156.3 million and $19.6 million for BPP, a UK based legal and financial training group, for it's poorer than expected performance in the enrolments for business and law courses. As a result, Apollo Group's operating loss increased $199.7 million during fiscal year 2010 compared to fiscal year 2009.

Looking forward, the weak economy is likely to boost the demand for greater education as workers find the pressing need to achieve a more advanced degree in order to succeed in the job market. The prospect of a high unemployment rate is likely to support the demand for the programs provided by Apollo Group for some time. On the other hand, the economic downturn may also increase the students' default rate on the loans, transferring into more bad debt expenses for Apollo Group, which recorded bad debt expense of $282.6 million, $152.5 million and $104.2 million during fiscal years 2010, 2009 and 2008, respectively. Moreover, the recession has reduced the availability of state-funded student financial aid as many states face revenue shortfalls. Analysts expect that the availability of state-funded student financial aid will continue to decline, which may adversely impact Apollo Group's enrollment and, to the extent that Title IV funds replace these state funding sources for their students, may adversely impact their 90/10 Rule calculation. This can potentially disqualify Apollo



Group from participating in Title IV programs, which provides loans from which Apollo Group derives more than 80% of their revenue.

Profitability and Growth

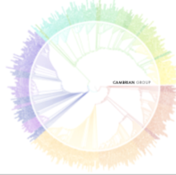
Figure 1	Historical Profitability Figures					
	2005	2006	2007	2008	2009	2010
Net Revenue						
USD Mil	2,251	2,478	2,724	3,141	3,974	4,926
Tuition and educational						
services revenue		2304	2553	2988	3815	4757.9
Educational Materials Revenue		138.7	161	184.4	226.4	324.9
Service Revenue		74	73.5	77.7	83.2	84.2
Others		65.5	49	43.9	28.3	22.4
Gross Profit	58.4	55.1	54.6	56.4	59.6	56.9
Operating Income	713	650	626	749	1,039	1,011
Earnings Before Taxes						
Net Income	444.73	414.83	408.81	476.52	598.32	521.58
Free Cash Flow	462	440	484	621	833	877
Source:	Apollo Group Annual Report, MorningStar					

As is shown in figure 1, Apollo Group generates its revenue mainly through tuition and educational service revenue. It has been generating positive revenue for the past 5 years, and reported a net income of 521.58 Mil in August 2010. Due to the economic downturn and its measures in response to the 90/10 rule, Apollo Group revised its promotion standards and implemented measure to help students take on loans more conservatively, this has negatively affected its enrollment in 2010 and led its gross profit to decline from 59.6 Million to 56.9 Million from 2009 to 2010.

Figure 2	Key Profitability Ratios 2010					
	Apollo	DeVry	Education Management	Corinthian Colleges	Inudstry Median	Market Median
Gross Profit	56.94%	57.41%	49.66%	42.87%	56.69%	30.37%
Pre-tax profit margin	20.36%	22.59%	10.75%	0.09%	17.21%	9.38%
Net Profit Margin	10.98%	15.12%	7.17%	-2.93%	4.55%	4.03%
Return on Equity	38.03%	27.22%	10.52%	-9.93%	9.12%	6.11%
Return on Assets	16.51%	18.00%	4.16%	-5.82%	4.65%	1.01%
Return on Invested Capital	33.66%	26.70%	5.39%	-8.15%	7.12%	2.79%

Source: Hoovers

Figure2 shows Apollo's profitability relative to its competitors. As many of Apollo's programs are offered online and the school has very little



investment in facilities relative to campus colleges and universities, its main competition comes from other online schools such as DeVry. Apollo's profit margin and return on assets are about 2 percent points lower than DeVry's, whereas its return on equity and return on capital are significantly higher than DeVry's and than industry median. Apollo's high return on equity and capital reflects it's non-capital-intensive nature of business. Apollo expects to double their capital expenditures in fiscal year 2011 so as to invest in more core information technology and network infrastructure.

Figure 3	Key Historical Profitability Ratios					
	2005	2006	2007	2008	2009	2010
Return on Equity	53.45	63.27	66.03	64.92	60.08	44
Return on Assets	32.28	32.08	29.92	28.79	23.35	16.11
Gross Margin	58.44	55.09	54.57	56.35	59.65	56.86
Operating Margin	31.66	26.24	22.97	23.86	26.16	20.52
Pre-tax profit margin	32.42	26.97	24.13	24.92	26.16	20.32
net margin	19.75	16.74	15.01	15.17	15.06	11.23

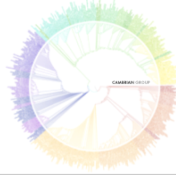
Source: Morningstar

As shown in figure3, Apollo's gross margin has fluctuated over the years whereas its net margin has seen a steady decline over the past five years. Given the highly regulated nature of the education industry and intensifying competitions from traditional universities, this trend is likely to continue into the future. The net operating loss from the company's foreign subsidiaries can explain the dramatic decrease in operating margin from 2009 to 2010.

Solvency and Liquidity

Figure 4	Key Financial Ratios 2010					
	Apollo	DeVry	Education Management	Corinthian Colleges	Industry Median	Market Median
Current Ratio	1.26	1.45	1.37	1.47	1.47	1.46
Quick Ratio	0.86	1.29	1.13	1.09	1.2	1.37
Leverage Ratio	2.66	1.38	2.17	2.01	1.98	5.92
Total Debt-to-Equity	0.43	0	0.74	0.43	0.26	1.11
Interest coverage	92.14	406.41	/	1.22	14.95	7.97

Source: Hoovers

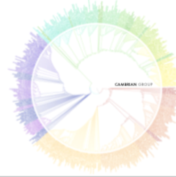


As shown in figure 4, Apollo's current ratio is below industry median, which shows that Apollo is less capable of paying back its short-term liabilities than its competitors. The current ratio gives a sense of Apollo's efficiency in its operating cycles compared to its competitors. Apollo has a quick ratio that is lower than all of its competitors, which means that it will have more difficulties meeting its short-term debt than its competitors. The leverage ratio indicates that Apollo is more leveraged than its competitors and will have more difficulties in meetings its financial obligations.

Figure 5	Key Historical Financial Ratios					
	2005	2006	2007	2008	2009	2010
Current Ratio	1.61	1.35	1.24	1.35	1.07	1.26
Quick Ratio	1.1	0.87	0.75	0.82	0.72	0.86
Leverage Ratio	1.84	2.12	2.29	2.23	2.82	2.66
Long term Debt-to-Equity	0.11	0.14	0.11	0.19	0.30	0.33

Source: Morningstar

As shown in figure 5, Apollo Group's debt burden has grown significantly over the past five years. Its quick ratio underscores its inability to meet its current liabilities. The increase in leverage ratio indicates that Apollo Group took on more debt over the years, mostly to finance its acquisition of different educational institution both domestically and internationally. It's low long-term debt-to-equity ratio shows that it has a lot of short-term debt but less long-term debt.



Operational Efficiency

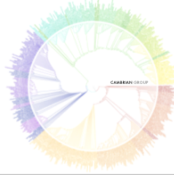
Figure 6	Key Operational Ratios 2010					
	Apollo	DeVry	Education Management	Corinthian Colleges	Industry Median	Market Median
Days of sales outstanding	21.85	25.22	18.16	14.46	25.43	45.69
Days COGS inventory	/	/	3.88	/	4.77	51.93
Asset Turnover	1.5	1.19	0.58	1.99	1.02	0.25
Net Receivables Turnover Flow	16.7	14.47	20.1	25.25	14.36	7.99
Effective Tax Rate	47.58%	33.06%	33.37%	3365.31%	/	/
Source: Hoovers						

As showed in figure 6, Apollo has higher days of sales outstanding than the Education Management Group and Corinthian Colleges. This shows that it is taking longer for Apollo Group collect money from their students. Given its high burden on current liabilities and the growing likelihood of students to default under the economic downturn, this is a concern. Apollo Group's asset turnover ratio is higher than industry median, which shows that it is quite efficient in using its assets to generate revenue, it should also be kept in mind that given a lot of courses are taught online, it has less asset requirement than conventional schools. University of Phoenix Degreed Enrollment for the quarter ended August 31, 2010 was 470,800, a 6% increase from 2009.

Figure 7	**Key Historical Operational Ratios**					
	2005	**2006**	**2007**	**2008**	**2009**	**2010**
Days of sales outstanding	28	26.48	22.95	23.47	23.89	20.85
Asset Turnover	1.63	1.92	1.99	1.9	1.55	1.44
Net Receivables Turnover Flow	13.04	13.78	15.9	15.55	15.28	17.51

Source: Morningstar

The net receivable turnover flow can help determine bad debt risk. A rising ratio, as seen between 2005 and 2007 in Figure 7, indicates that Apollo faced cash flow problems and could not pay its account balances. A decline in net receivable turnover flow between 2008 and 2009 reflects that AMD



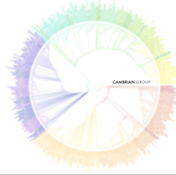
has taken steps to improve the rate at which the firm collects its accounts receivable. The increase from 2009 to 2010 reflects the increase in uncollectible accounts receivable in 2010. The decrease in days sales outstanding from 2010 to 2009 can be attributed to a more pronounced seasonal increase in accounts receivable at August 31, 2009 due to University of Phoenix annual student financial aid system enhancements and upgrades.

Market Valuation

Figure 8	Market Valuation		
	Apollo	DeVry	Education Management
Current Price ($)	42.99	53.28	20.02
Market Capitalization (Billion)	6.15	3.69	2.81
Price/Earnings	11.79	12.14	15.27
PEG ratio	0.93	0.93	0.91
Price/Book(TTM)	4.3	2.9	1.3
Price/Cash Flow(TTM)	6.1	9.5	8.5
Price/Sales(TTM)	1.23	1.78	1.07

Source: Morningstar, Yahoo Finance

As reflected in the market capitalization in figure 8, Apollo Group is significantly bigger than its rivals. Apollo Group's price-to-earnings ratio is lower than both of its rivals, which indicates that investors expect higher earnings growth in the future for DeVry and Educational Management Corporation. The price-to-earnings to growth ratio shows that Educational Management Corporation may be undervalued compared to Apollo Group and DeVry. This conclusion is supported by EMDC's price-to-book ratio, which is lower than both Apollo and DeVry.

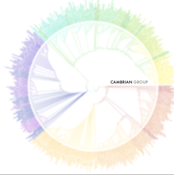


SWOT ANALYSIS

Location of Factor	TYPE OF FACTOR	
	Favorable	**Unfavorable**
Internal	**Strengths** ➢ Industry Leader ➢ Management and Governance ➢ Balance Sheet	**Weaknesses** ➢ Negative Public Perception ➢ Short-term Profitability Issues ➢ Market Concentration ➢ Dependence on Title IV ➢ BPP Cost Base
External	**Opportunities** ➢ International Expansion ➢ Growing demand ➢ Corporate Relationships	**Threats** ➢ Revised Regulatory Programs ➢ Intense Competition ➢ Increased Student Loan Defaults ➢ International Operations Risk

Strengths

- Industry leader in proprietary education with an advantage in both technological capabilities and education model
    - Intense focus on convenience and service lead to the student being viewed as a customer
    - Strong brand name and core services through the use of placement results and skills assessments
    - Successful leveraging of economies of scale in marketing, regulatory compliance serve as strong barriers to entry
- Visionary management and quality governance
    - Strong management team including founder and Chairman of the Board Dr. John Sperling

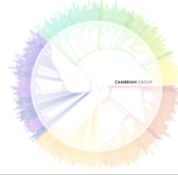


- Development and utilization of separate hierarchical structures to handle the business and academic dimensions of the business
- Continued commitment to an economically sound business model built for the long-term

- Strong Balance Sheet
  - Abundance of cash and short-term cash equivalents allows the firm to make strategic purchases and stand ready to defend itself from litigation and competition
  - Leasing of properties increases liquidity while reducing capital costs and affords the organization to quickly expand operations to new locations (operational within six months)

Weaknesses

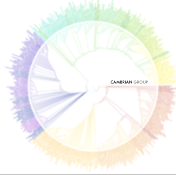
- Apollo Group faces a negative public perception issue surrounding three primary issues
  - A strong focus on the professional training aspect while placing a relatively low importance on general education courses
  - A reliance on almost an entirely part time faculty resulting in degrees being awarded substantially less faculty input than a traditional post-secondary education
  - Absence of original research, scholarly publications and the realization that Apollo Group could not operate without the works of traditional schools
- Short-term profitability decline
  - A mandatory orientation for new enrollees has resulted in decreased enrollment thereby decreasing tuition revenues
  - Government pressure has forced Apollo Group to bring significant changes to their marketing programs including the acquisition and integration of Aptimus, Inc. further increasing marketing costs
  - Increased enrollment by students with less than 24 transfer credits has increased bad debt exposure and decreased completion rates
- Market concentration



  - Dependence on Title IV revenue leaves the schools very exposed to economic and regulatory forces
- Reliance on Title IV programs
  - Apollo currently derives 82 percent of total from various government programs
- Inability to capitalize on BPP and other international expansion projects could lead to large write down negatively impact margins
  - Large fixed associated with BPP are not consistent with domestic investment expansion programs

Opportunities

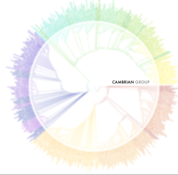
- Continued use of joint ventures and room for intelligent international expansion
  - Further develop BPP under the Apollo Global joint venture to exploit regulator-approved monopoly of United Kingdom for-profit educators
  - Use of joint ventures allows for the spreading of large fixed costs associated with fixed start-up costs abroad
  - Leverage existing scale economies in marketing, technology and regulatory compliance aboard where possible
- Growing demand for non-traditional post-secondary education
  - Strong demand forecast as domestic economy continues shift towards knowledge based services and manufacturing
  - Continued targeting of non-traditional learners who are price and time sensitive
  - Shortage of qualified healthcare and teaching professionals
- A renewed emphasis on relationship building with large corporation
  - Potential for revenue diversification as employers may provide tuition assistance to enrolled employees reducing reliance on Title IV programs
  - Large and stable corporate partners offer the potential of a steady stream of degree and certification candidates both domestically and internationally
  - Better recognition of the value of the Apollo Group's degrees and certifications amongst industry leaders



- Better implementation of price discrimination policies by way of online platforms
    - Online users may be willing to pay a premium for reduced commute times and ease of use
    - Implementation of data gathering software may allow for further price discrimination

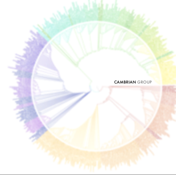
Threats

- Revised regulatory programs could compromise the business model or profitability
    - Changes in the availability of education subsidy programs, such as Pell Grants, could render the business obsolete
    - Current budget constraints on both federal and state level could negatively affect education subsidies and therefore revenue
    - Changes in accreditation requirements could result in a loss of programs' eligibility for tuition assistance
- Intense competition amongst mature competitors
    - Inability to provide a consistent, superior education service in highly concentrated market
    - Inability to generate referral business could lead to increased marketing costs and declining profitability
    - Inability to keep competitive advantage in distance learning and online segment of markets
- Increase in student loan default rate could lead to the loss of Title IV funding
    - Could be further impacted by lagged effect of bad debt exposure due to past economic downturn
- International operations come with more inherent risks including but not limited to the following
    - Compliance with changing and potentially unscrupulous foreign regulatory regimes
    - Difficulty enforcing utilizing and enforcing intellectual property rights and protection
    - Potential failure to understand the market dynamics and adapt the business model



PART III

RECOMMENDATIONS



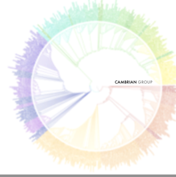
STRATEGIC RECOMMENDATIONS

Cambrian will address the strategic and decisions facing Apollo Group's business model in the near, intermediate and long terms. This section will first provide a current background of each issue and provide strategic recommendations that we believe to be in Apollo Group's best interest. The issues touched upon follow from the SWOT analysis above. These recommendations make special note of Apollo Group's existing corporate strategy and seek to enhance the long-term viability of the business model. The principal theme of these recommendations will be a strategy to both increase short-term profitability and comply with changing regulatory conditions.

Near Term

The proprietary education industry has recently experienced several obstacles: declining profitability and increased regulatory scrutiny. These issues are especially salient for the Apollo Group and have created a difficult environment for the company in the near term given the organization has implemented measures to correct these weaknesses that have in reduced enrollment. In the past, Apollo Group has operated in good economic times leading to increased enrollment and high profit margins. This trend has recently reversed course as net revenue has increased by 24.6 percent to $972.2 million in fiscal year 2010 but the net profit margin has fallen by 12.2 percent over the corresponding period to 10.6 percent. While some this change is due to the cost of BPP, the result has also been driven by two primary domestic factors: increased enrollment of under-qualified students leading to higher rates of loan default and increased marketing costs. By reducing rates of loan defaults, the Apollo Group will also take steps necessary to ensure the continued availability of Title IV federal funds.

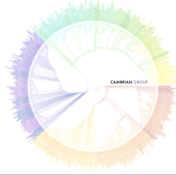
Bad debt expense from student loan defaults has increased to 5.7 percent of net revenue in fiscal year 2010 from just 3.8 percent in fiscal year 2009 representing an increase of 50 percent. This increase can be attributed to two factors: the lagged effects of the economic downturn and an increase in



the proportion of students with less than 24 incoming credits.[xvi] We will largely discuss the economic effects through mechanism of loan defaults in younger students. The Apollo Group does not publish demographic data related to the number of incoming credits but given that the University of Phoenix awards transfer credit through the Prior Learning Assessment program which gives students credit for professional training and life experiences it be assumed that these are younger students. Indeed 44.7 percent of the total degreed enrollment was under the age of 30 in 2010 and Apollo notes that the proportion of students with less than 24 credits entering bachelors programs has continued to rise.[xvii] This provides a unique challenge for Apollo given that in addition to having higher loan default rates, these students also have a higher cost per enrollee, lower retention rates, higher student service costs while also leaning heavily on Title IV programs drawing Apollo ever closer to the 90/10 Rule. These students also provide another difficulty for Apollo in that they limit the tuition pricing power of Apollo. Title IV programs generally provide a fixed amount of funding making increases in tuition inherently risky as students will bear a larger portion of the overall cost.

The Cambrian Group recommends that Apollo use two methods to enhance the selection and enrollment of students: continue the University Orientation Program, and increase price discrimination practices. We believe the successful implementation of these practices in the near-term, while leading possibly leading to a near-term reduction in enrollment, will be in the best long-term interest of the Apollo Group.

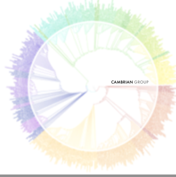
The Cambrian Group recommends that Apollo continue their recently implemented three-week University Orientation program while vigorously targeting students who better have the ability to succeed in the education programs. The orientation program was piloted during 2009 and fully implemented in November 2010. The program requires prospective students with less than 24 credits attend a free three-week program that aims to educate then about the gravity of the financial burden and substantial time commitment that post-secondary education will carry. This program must be completed prior to enrollment. By forcing potential students to better evaluate themselves, the Apollo Group should be able to reduce the proportion of students that will leave without degrees. This will



translate to higher rates of completion and potentially higher rates of repayment.

Cambrian recommends that Apollo Group continue and increase the use of price discrimination practices where possible. Since Apollo has established itself as a market leader in its field, the use of price discrimination should help increase profitability while also helping to steer new enrollment. After experiencing a 37 percent increase in associate's degreed enrollment between fiscal years 2008 and 2009, Apollo instituted a 10 percent tuition increase to help reduce associate's degreed enrollment in anticipation of elevated costs and future loan defaults. This tuition increase helped to reduce new enrollment in associate's programs by 20 basis points while overall new enrollment increased by 6 percent. We see the online learning center as having high potential for Apollo to successfully price discriminate. The student clients using this service avail themselves to a "distance-learning premium" that Apollo should take every step to capture. By continuing to offer price discounts to veteran military personnel, Apollo is gaining access to a large and stable clientele. We also believe that this group of potential students will more likely to repay loans. A potentially unseen benefit to targeting returning soldiers could be increased referral rates. If soldiers successfully complete these programs and find civilian employment, other returning soldiers will take note. As mentioned above, Apollo's marketing department has recently seen costs rise and an increase in referral rates not only cements Apollo's market leading reputation but also reduces marketing costs.

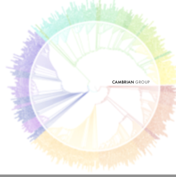
While these program may continue to reduce enrollment in near-term, we agree with Apollo's management team that it is a prudent step to ensure the long-term success of the business model. Predictably, new degreed enrollment has fallen by over 43 percent for the first six months of fiscal year 2011 compared to the same period in 2010. This enrollment decrease has resulted in a year over year net revenue drop of 2 percent but has also reduced Apollo Group's provision for uncollectible students by 260 basis points as a percentage of net revenue.[xviii] Cambrian believes that Apollo's management has done an effective job of realizing near-term threats and aggressively implementing strategies to address and eliminate the threats.



Intermediate-term: Corporate Relationship Building & Degree Focus

Despite Apollo Group's recent struggles with student selection and enrollment, the Cambrian Group believes that Apollo should continue to cultivate corporate training relationships. Corporate training relationships provide several benefits to the Apollo Group including: increased revenue from employer-paid programs, decreased reliance on federal and state accreditation, and increased recognition of the Apollo Group's various degrees. The competition for training contracts is fierce and may result increasing marketing costs but the Cambrian Group believes that the potential benefits outweigh the increased marketing costs. While management is clearly aware of the benefits of corporate relationships, we believe they should allocate more resources to this potentially lucrative opportunity. The prospect of diversifying revenue streams to include more employer-paid tuition revenue cannot be passed on. With the University of Phoenix deriving 88 percent of its total tuition revenue from Title IV programs, the prospect of increasing employer-paid programs by even 5 percent would allow the University of Phoenix to move well under the 90/10 Rule. The Cambrian Group further believes that revenue diversification will benefit Apollo by increasing employer input. That is, increased employer interaction could potentially aid Apollo in the design of their other course offerings.

Beyond the financial benefits of corporate relationships, there are also important non-monetary benefits including the increased recognition of Apollo degrees and a reduced reliance on accredited degree program. Corporations that have successful relationships with Apollo will better recognize the value of the other programs that Apollo offers. This will potentially allow Apollo to recognize marketing economies of scale and increase referral rates. Finally, corporate relationship building has the potential for Apollo to leverage its existing capabilities into training programs that do not require federal and/or state accreditation. A good example of this could be information technology training tailored to

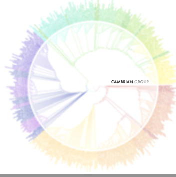


specific corporations. These programs, while valuable to enrollees and corporations, may not expose Apollo to changing regulatory requirements.

To further address exposure to bad debt and the higher per student enrollment cost of the associate's degree programs, the Cambrian Group recommends that the Apollo Group focus on bachelor's, master's and doctoral degrees. We believe that these degrees offer two specific financial benefits: lower cost per student and increased diversification of revenues. Despite the increased instructional costs associated with doctoral programs, the increased rates of repayment and diminished reliance on Title IV programs result in lower per student costs and make these programs a valuable source of revenue. Apollo must be careful to expand these programs intelligently as they will increasingly compete with traditional schools for students. Additionally, we see an increase in these programs helping to tackle the negative public perception associated with the acceptance of federal funds for associates and lower level certifications.

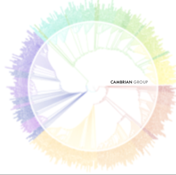
Long-term: Maximization of UOP Brand Name & International Growth

In the long-term, the Cambrian Group recommends that the Apollo Group place a very heavy emphasis on the University of Phoenix brand name and strive to maximize its reputational potential. Simply put, the for-profit education industry is one that is characterized by reputation. John Sperling developed the University of Phoenix into the industry leader by realizing that a long-term approach was necessary to accomplish this. By continually improving the quality of the educational experience, improving student outcomes through increased job placement rates and enhancing the overall student experience, the Apollo Group can strengthen and grow revenues over the long-term. To this end, management's decisions to implement measures that reduce current enrollments and tuition revenue can be seen as key to the long-term success of the company. To better understand this argument, the Cambrian Group will briefly discuss the economics of reputational equilibriums and how they apply to the Apollo Group.

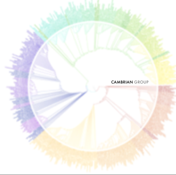


In the past, it was the view of economists like Akerloff that sellers of adjustable goods and services, such as educational services, were not governed by reputational equilibriums. As the buyer cannot assess the quality of educational services until after s/he has completed the program and is seeking employment, it was claimed that educational services could promise high quality programs and deliver low quality ones. While this argument may be theoretically appealing for goods where buyers and sellers interact infrequently, the market for education is somewhat unique. The argument follows that while an individual buyer and the seller may not interact again, the opinion that the original buyer holds of the seller equates to the transaction being repeated. In sum, while a customer may not buy another certification or degree from the Apollo Group, a poor product will reduce placement rates thereby lowering the reputation of Apollo. As mentioned above, increasing placement rates and starting salaries create more referrals, which in turn, lower market costs and so on.[xix] Despite theoretical challenges to this indirectly repeated game framework, it is clear that Apollo Group's business is adversely affected by a negative reputation and that it is in management's best interests to continue to deliver a quality product.

Beyond the value of Apollo's brand name, the Cambrian Group recommends that Apollo continue entry into international markets. According to the United Nations Educational, Scientific and Cultural organization Institute for Statistics, there were approximately 153 million students participating in postsecondary education worldwide in 2007. The Cambrian Group believes that this could lead to significant revenue for the Apollo Group if they are able to successfully gain international market share. One of the many issues facing companies looking to outsource their production is the availability of an educated labor force. While government programs may teach the basics, proprietary educators should look to exploit the shortfall of quality post-secondary education. The Apollo Group should pay specific attention to the needs of large multinational corporations as their demand for employees could aid in new market penetration and saturation. This is essentially the same market space that exists in the domestic markets but on a much larger scale.



While there are many drivers for post-secondary education in the international markets we agree with the Apollo Group that an increasingly global economy is driving the need for more knowledge-based job training and education. As the availability of education continues to increase, an accompanying appreciation for the benefits of an educated workforce should continue to drive global demand for job training. In a world still recovering from the deep recession of 2007 through 2009, government budgets are not allocating the amounts of capital they once were to post-secondary education. This provides an opportunity for Apollo to leverage its superior product portfolio abroad and experience significant returns from the economies of scale and scope that the company already benefits from in the United States.



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