CAPELLA EDUCATION CO
Form 10-Q
October 23, 2012
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES AND EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2012
or

o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from to
Commission File Number: 001-33140

CAPELLA EDUCATION COMPANY
(Exact name of registrant as specified in its charter)

Minnesota (State or other jurisdiction of incorporation or organization)	41-1717955 (I.R.S. Employer Identification No.)
Capella Tower 225 South Sixth Street, 9th Floor Minneapolis, Minnesota (Address of principal executive offices)	55402 (Zip Code)

(888) 227-3552
(Registrant’s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act.

Large accelerated filer	x	Accelerated filer	o
Non-accelerated filer	o (Do not check if a smaller reporting company)	Smaller reporting company	o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No x
The total number of shares of common stock outstanding as of October 18, 2012 was 12,711,539.

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PART I – FINANCIAL INFORMATION

Item 1. Financial Statements

CAPELLA EDUCATION COMPANY
Consolidated Balance Sheets
(In thousands, except par value)

	As of September 30, 2012 (Unaudited)	As of December 31, 2011
ASSETS		
Current assets:		
Cash and cash equivalents	$99,294	$61,977
Marketable securities	18,093	65,067
Accounts receivable, net of allowance of $5,090 at September 30, 2012 and $5,789 at December 31, 2011	17,559	18,239
Prepaid expenses and other current assets	12,161	12,493
Deferred income taxes	3,101	3,452
Total current assets	150,208	161,228
Property and equipment, net	46,946	50,713
Goodwill	16,916	16,980
Intangibles, net	5,143	6,552
Total assets	$219,213	$235,473
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$8,951	$8,977
Accrued liabilities	23,226	29,306
Income taxes payable	—	2,427
Deferred revenue	11,710	7,769
Total current liabilities	43,887	48,479
Deferred rent	4,149	4,215
Other liabilities	6,564	6,425
Deferred income taxes	10,521	12,575
Total liabilities	65,121	71,694
Redeemable noncontrolling interest	—	1,180
Shareholders' equity:		
Common stock, $0.01 par value: Authorized shares — 100,000; Issued and Outstanding shares — 12,799 at September 30, 2012 and 13,882 at December 31, 2011	128	139
Additional paid-in capital	98,670	103,900
Accumulated other comprehensive income	86	307
Retained earnings	55,208	58,253
Total shareholders' equity	154,092	162,599
Total liabilities and shareholders' equity	$219,213	$235,473

The accompanying notes are an integral part of these consolidated financial statements.

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CAPELLA EDUCATION COMPANY
Consolidated Statements of Income
(In thousands, except per share amounts)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
	(Unaudited)			
Revenues	$99,309	$102,306	$314,889	$320,061
Costs and expenses:				
Instructional costs and services	44,398	42,523	136,190	127,528
Marketing and promotional	32,964	33,673	98,537	99,812
General and administrative	13,664	11,253	35,886	29,631
Reduction of workforce	—	—	—	1,862
Total costs and expenses	91,026	87,449	270,613	258,833
Operating income	8,283	14,857	44,276	61,228
Other income (expense), net	(21)	477	(4)	1,474
Income before income taxes	8,262	15,334	44,272	62,702
Income tax expense	3,139	5,549	16,630	23,037
Net income	5,123	9,785	27,642	39,665
Net loss attributable to noncontrolling interest	—	149	186	394
Net income attributable to Capella Education Company	$5,123	$9,934	$27,828	$40,059
Net income attributable to Capella Education Company per common share:				
Basic	$0.39	$0.66	$2.08	$2.57
Diluted	$0.39	$0.66	$2.07	$2.56
Weighted average number of common shares outstanding:				
Basic	12,974	15,006	13,351	15,588
Diluted	13,033	15,062	13,412	15,668

The accompanying notes are an integral part of these consolidated financial statements.

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CAPELLA EDUCATION COMPANY
Consolidated Statements of Comprehensive Income
(In thousands)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
	(Unaudited)			
Net income	$5,123	$9,785	$27,642	$39,665
Net loss attributable to noncontrolling interest	—	149	186	394
Net income attributable to Capella Education Company	5,123	9,934	$27,828	$40,059
Other comprehensive gain (loss), net of tax:				
Foreign currency translation gain (loss)	103	(7)	22	(7)
Unrealized losses on available for sale securities	(52)	(179)	(243)	(329)
Comprehensive income attributable to Capella Education Company	$5,174	$9,748	$27,607	$39,723

The accompanying notes are an integral part of these consolidated financial statements.

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CAPELLA EDUCATION COMPANY
Consolidated Statements of Cash Flows
(In thousands)

	Nine Months Ended September 30,	
	2012	2011
	(Unaudited)	
Operating activities		
Net income	$27,642	$39,665
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for bad debts	11,997	6,744
Depreciation and amortization	21,721	17,369
Amortization of investment discount/premium	590	1,663
Impairment of property and equipment	1,150	35
Loss (gain) on disposal of property and equipment	78	(38)
Share-based compensation	3,108	3,191
Excess tax benefits from share-based compensation	(64)	(70)
Deferred income taxes	(1,577)	4,873
Changes in operating assets and liabilities:		
Accounts receivable	(11,337)	(9,453)
Prepaid expenses and other current assets	2,329	(5,596)
Accounts payable and accrued liabilities	(5,710)	(3,569)
Income tax payable	(5,164)	(625)
Deferred rent	(66)	765
Deferred revenue	3,988	756
Net cash provided by operating activities	48,685	55,710
Investing activities		
Capital expenditures	(17,964)	(20,020)
Proceeds from the sale of property and equipment	303	—
Payment for acquisition, net of cash acquired	—	(12,640)
Redemption of noncontrolling interest	(1,576)	—
Purchases of marketable securities	(653)	(3,500)
Sales and maturities of marketable securities	46,650	30,685
Net cash provided by (used in) investing activities	26,760	(5,475)
Financing activities		
Excess tax benefits from share-based compensation	64	70
Net proceeds from exercise of stock options	577	1,558
Repurchases of common stock	(38,764)	(77,271)
Net cash used in financing activities	(38,123)	(75,643)
Effect of foreign exchange rates on cash	(5)	12
Net increase (decrease) in cash and cash equivalents	37,317	(25,396)
Cash and cash equivalents at beginning of period	61,977	77,416
Cash and cash equivalents at end of period	$99,294	$52,020
Supplemental disclosures of cash flow information		
Income taxes paid	$23,449	$22,160
Noncash transactions:		
Purchase of equipment included in accounts payable and accrued liabilities	$433	$1,277

The accompanying notes are an integral part of these consolidated financial statements.

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CAPELLA EDUCATION COMPANY
Notes to Consolidated Financial Statements
(Unaudited)

1. Nature of Business

Capella Education Company (the Company) was incorporated on December 27, 1991, and is the parent company of its wholly owned subsidiaries, Capella University (the University), Resource Development International Limited (RDI), and Sophia Learning, LLC (Sophia). The University, founded in 1993, is an online postsecondary education services company offering a variety of bachelor's, master's and doctoral degree programs primarily delivered to working adults. The University is accredited by The Higher Learning Commission and is a member of the North Central Association of Colleges and Schools. In 2011, the Company acquired RDI, which is an independent provider of United Kingdom (UK) university distance learning qualifications and markets, develops and delivers programs worldwide via its offices and partners across Asia, North America, Africa and Europe. Sophia provides a social teaching and learning platform that integrates education with technology. On April 16, 2012, the Company acquired the remaining interest in Sophia which is now a wholly owned subsidiary as of that date.

2. Summary of Significant Accounting Policies

Consolidation
The consolidated financial statements include the accounts of the Company, the University, RDI and its subsidiaries, and Sophia, after elimination of intercompany accounts and transactions. RDI operates on a fiscal year ending October 31.

Unaudited Interim Financial Information
The accompanying unaudited consolidated financial statements of the Company have been prepared in accordance with accounting principles generally accepted in the United States (GAAP) for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, these statements include all adjustments (consisting of normal recurring adjustments) considered necessary to present a fair statement of the Company's consolidated results of operations, financial position and cash flows. Operating results for any interim period are not necessarily indicative of the results that may be expected for the full year. Preparation of the Company’s financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts in the financial statements and footnotes. Actual results could differ from those estimates. This Quarterly Report on Form 10-Q should be read in conjunction with the Company’s consolidated financial statements and footnotes included in its Annual Report on Form
10-K for the fiscal year ended December 31, 2011 (2011 Annual Report on Form 10-K).

Use of Estimates
The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts in the consolidated financial statements and accompanying notes. Actual results could differ from those estimates.

Subsequent Events
The Company has reviewed and evaluated events and transactions that occurred subsequent to the balance sheet date. There have been no subsequent events that require recognition or disclosure in the financial statements.

Refer to the Company’s “Summary of Significant Accounting Policies” footnote included in its 2011 Annual Report on Form 10-K for a complete summary of the Company’s significant accounting policies.

3. Recent Accounting Pronouncements

In May 2011, the Financial Accounting Standards Board (FASB) issued Accounting Standard Update (ASU) No. 2011-04, Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S GAAP and IFRS, which is included in Accounting Standards Codification (ASC) 820, Fair Value Measurement. This update defines fair value, clarifies a framework to measure fair value, and requires specific disclosures of fair value measurements. The guidance is effective for the Company's interim and annual reporting periods beginning January 1, 2012, and applied prospectively. The adoption of this guidance did not have a material impact on the Company's financial condition, results of operations, or disclosures.

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In September 2011, the FASB issued ASU No. 2011-08, Testing Goodwill for Impairment, which is included in ASC 350, Intangibles-Goodwill and Other. This update reduces the complexity, and potentially the cost, of testing goodwill for impairment. The guidance gives the Company the option to perform a qualitative assessment to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount, and in some cases skip the two-step impairment test. The guidance is effective for the Company's interim and annual reporting periods beginning January 1, 2012, and applied prospectively. The adoption of this guidance did not have a material impact on the Company's financial condition, results of operations, or disclosures.

The Company has reviewed and considered all recent accounting pronouncements and believes there are none that could potentially have a material impact on its financial condition, results of operations, or disclosures.

4. Net Income Attributable to Capella Education Company per Common Share

Basic net income attributable to Capella Education Company per common share is based on the weighted average number of shares of common stock outstanding during the period. Dilutive shares are computed using the Treasury Stock method and include the incremental effect of shares that would be issued upon the assumed exercise of stock options and the vesting of restricted stock.
The following table presents a reconciliation of the numerator and denominator in the basic and diluted net income attributable to Capella Education Company per common share calculation, in thousands, except per share data:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Numerator:				
Net income attributable to Capella Education Company	5,123	9,934	27,828	40,059
Denominator:				
Denominator for basic net income attributable to Capella Education Company per common share—weighted average shares outstanding	12,974	15,006	13,351	15,588
Effect of dilutive stock options and restricted stock	59	56	61	80
Denominator for diluted net income attributable to Capella Education Company per common share—weighted average shares outstanding	13,033	15,062	13,412	15,668
Basic net income attributable to Capella Education Company per common share	$0.39	$0.66	$2.08	$2.57
Diluted net income attributable to Capella Education Company per common share	$0.39	$0.66	$2.07	$2.56

Options to purchase 0.6 million and 0.6 million common shares were outstanding, but not included in the computation of diluted net income per common share in the three months ended September 30, 2012 and 2011, respectively, because their effect would be antidilutive. Options to purchase 0.6 million and 0.5 million common shares were outstanding, but not included in the computation of diluted net income per common share in the nine months ended September 30, 2012 and 2011, respectively, because their effect would be antidilutive.

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5. Marketable Securities

The following is a summary of available-for-sale securities, in thousands:

	As of September 30, 2012			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Estimated Fair Value
Tax-exempt municipal securities	$18,026	$67	$—	$18,093
Total	$18,026	$67	$—	$18,093

	As of December 31, 2011			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Estimated Fair Value
Tax-exempt municipal securities	$64,613	$454	$—	$65,067
Total	$64,613	$454	$—	$65,067

The unrealized gains on the Company's investments in municipal securities as of September 30, 2012 and December 31, 2011 were caused by changes in market values primarily due to interest rate changes. The Company had no securities in an unrealized loss position as of September 30, 2012. No other-than-temporary impairment charges were recorded during the three and nine months ended September 30, 2012 and 2011.
The following table summarizes the remaining contractual maturities of the Company's marketable securities, in thousands:

	As of September 30, 2012	As of December 31, 2011
Due within one year	$16,663	$54,151
Due after one year through five years	1,430	10,916
Total	$18,093	$65,067

The following table summarizes the proceeds from the maturities of available-for-sale securities, in thousands:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Maturities of tax-exempt marketable securities	$14,615	$13,225	$46,650	$30,685
Total	$14,615	$13,225	$46,650	$30,685

The Company did not record any gross realized gains or gross realized losses in net income during the three and nine months ended September 30, 2012 and 2011.

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6. Fair Value Measurements

The following tables summarize certain information for assets and liabilities measured at fair value on a recurring basis, in thousands:

	Fair Value Measurements as of September 30, 2012 Using			
Description	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Cash and cash equivalents:				
Cash	$33,087	$ 33,087	$—	$—
Money market funds	1,867	1,867	—	—
Variable rate demand notes	64,340	64,340	—	—
Marketable securities:				
Tax-exempt municipal securities	18,093	—	18,093	—
Total assets at fair value on a recurring basis:	$117,387	$ 99,294	$18,093	$—
Liabilities:				
Other liabilities:				
RDI contingent consideration	$6,184	$ —	$—	$6,184
Total liabilities at fair value on a recurring basis:	$6,184	$ —	$—	$6,184

	Fair Value Measurements as of December 31, 2011 Using			
Description	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Cash and cash equivalents:				
Cash	$17,101	$17,101	$—	$—
Money market funds	27,551	27,551	—	—
Variable rate demand notes	17,325	17,325	—	—
Marketable securities:				
Tax-exempt municipal securities	65,067	—	65,067	—
Total assets at fair value on a recurring basis:	$127,044	$61,977	$65,067	$—
Liabilities:				
Other liabilities:				
RDI contingent consideration	$5,945	$—	$—	$5,945
Total liabilities at fair value on a recurring basis:	$5,945	$—	$—	$5,945

The Company measures cash and cash equivalents at fair value primarily using real-time quotes for transactions in active exchange markets involving identical assets. The variable rate demand notes contain a feature allowing the Company to require payment by the issuer on a daily or weekly basis. As a result, these securities are highly liquid and are classified as cash and cash equivalents. The Company's marketable securities are classified within Level 2 and are valued using readily available pricing sources for comparable instruments utilizing market observable inputs. The

Company does not hold securities in inactive markets. The Company did not have any transfers of assets between Level 1 and Level 2 of the fair value measurement hierarchy during the three and nine months ended September 30, 2012 and 2011.

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Level 3 Measurements

RDI Contingent Consideration

In connection with the acquisition of RDI, the Company is required to make an additional payment contingent on whether RDI is awarded Taught Degree Awarding Powers (TDAP) by the British Government. Refer to Note 10 for additional details regarding the acquisition of RDI. As the contingent consideration is classified as a liability, ASC 805 Business Combinations (ASC 805) requires that the Company re-measure the liability at fair value at each reporting date until it is extinguished. As such, the Company classified the RDI contingent consideration liability within Level 3 of the fair value measurement hierarchy.

The fair value of the RDI contingent consideration as of September 30, 2012 was determined using the discounted cash flow approach and was based on the present value of the probability-weighted expected cash flows based on the Company's estimates of the timing and probability of RDI being awarded TDAP. The discount rate reflects the risk of a market participant who holds the corresponding asset. To estimate the discount rate, the Company considered the market participant weighted average cost of capital of the business risk associated with RDI being awarded TDAP. The discount rate was then adjusted to incorporate risk-free rates and costs of debt for a term commensurate with the term in which the payment is expected to be made as well as the low probability risk of the contingent consideration payments not being made.

The fair value measurement of the RDI contingent consideration encompasses the following significant unobservable inputs:

Unobservable Inputs	Range
Weighted average cost of capital	5%
Timing of cash flows	0 - 33 months
Probability of TDAP achievement	100%

Significant increases or decreases in any of the unobservable inputs in isolation would result in a lower or higher fair value measurement of the RDI contingent consideration. An increase in the weighted average cost of capital would result in a decrease in the fair value, an acceleration of the timing of cash flows would increase the fair value, and a decrease in the probability that TDAP will be achieved would reduce the fair value. Reasonable changes in the unobservable inputs do not result in a material change in the fair value.

The following table presents a reconciliation of the fair value of the RDI contingent consideration, in thousands:

Balance, December 31, 2011	$5,945
Accretion of RDI contingent consideration liability	239
Balance, September 30, 2012	$6,184

The increase in the fair value of the RDI contingent consideration liability was recorded in other income (expense), net during the three and nine months ended September 30, 2012.

7. Accrued Liabilities

Accrued liabilities consist of the following, in thousands:

	As of September 30, 2012	As of December 31, 2011
Accrued compensation and benefits	$5,092	$8,978
Accrued instructional	5,451	7,291
Accrued vacation	1,900	994

Other	10,783	12,043
Total	$23,226	$29,306

“Other” in the table above consists primarily of vendor invoices accrued in the normal course of business.

The Company recorded liabilities of approximately $1.9 million and $1.3 million relating to the strategic reductions in workforce in February and November 2011, respectively, which were recorded as a component of accrued liabilities. The following presents the Company's reduction in workforce liability for the nine months ended September 30, 2012, in thousands:

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Balance, December 31, 2011	$967
Payments	967
Balance, September 30, 2012	$—

8. Commitments and Contingencies

Operating Leases
The Company leases its office facilities and certain office equipment under various noncancelable operating leases and has contractual obligations related to certain software license agreements. Effective August 29, 2011, the Company entered into an amendment of its current lease with Minneapolis 225 Holdings, LLC pursuant to which the Company renewed and extended its existing lease for premises at 225 South Sixth Street in Minneapolis, Minnesota through 2018. Renewal terms under this lease allow the Company to extend the current lease for up to two additional five-year terms.

The following presents the Company's future minimum lease commitments as of September 30, 2012, in thousands:

2012	$1,615
2013	6,423
2014	6,299
2015	6,239
2016	6,401
2017 and thereafter	12,120
Total	$39,097

The Company recognizes rent expense on a straight-line basis over the term of the lease, although the lease may include escalation clauses providing for lower payments at the beginning of the lease term and higher payments at the end of the lease term. Cash or lease incentives received from lessors are recognized on a straight-line basis as a reduction to rent from the date the Company takes possession of the property through the end of the lease term. The Company records the unamortized portion of the incentive as a component of deferred rent, in accrued liabilities or long-term liabilities, as appropriate.

Revolving Credit Facility
On September 30, 2011, the Company entered into an unsecured revolving credit agreement (the Credit Agreement) with Bank of America, N.A., and certain other lenders. The Credit Agreement provides $100.0 million of borrowing capacity (the credit facility), with an increase option of an additional $50.0 million. The Credit Agreement expires on September 30, 2016.

Borrowings under the Credit Agreement bear interest at a rate equal to LIBOR plus an applicable rate of 1.75% to 2.25% based on the Company’s consolidated leverage ratio or, at the Company’s option, an alternative base rate (defined as the higher of (a) the federal funds rate plus 0.5%, (b) Bank of America’s prime rate, or (c) the one-month LIBOR plus 1.0%) plus an applicable rate of 0.75% to 1.25% based on the Company’s consolidated leverage ratio. The Credit Agreement requires payment of a commitment fee, based on the Company’s consolidated leverage ratio, charged on the unused credit facility. Outstanding letters of credit are also charged a fee, based on the Company’s consolidated leverage ratio. The Company capitalized approximately $0.5 million of debt issuance costs related to the credit facility, which are being amortized on a straight-line basis over a period of five years. Interest expense for the amortization of debt issuance costs is recorded in other income (expense), net.
The Credit Agreement contains certain covenants that, among other things, require maintenance of certain financial ratios, as defined in the agreement. Failure to comply with the covenants contained in the Credit Agreement will constitute an event of default and could result in termination of the agreement and require payment of all outstanding

borrowings. As of September 30, 2012, there were no borrowings under the credit facility and the Company was in compliance with all debt covenants.

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Litigation
In the ordinary conduct of business, the Company is subject to various lawsuits and claims covering a wide range of matters including, but not limited to, claims involving learners or graduates and routine employment matters. While the outcome of these matters is uncertain, the Company does not believe the outcome of these matters will have a material adverse impact on its consolidated financial position or results of operations.

9. Share Repurchase Program

The Company announced its current share repurchase program in July 2008. The Board of Directors authorizes repurchases of outstanding shares of common stock from time to time depending on market conditions and other considerations. A summary of the Company's comprehensive share repurchase activity from the program's commencement through September 30, 2012, all of which was part of its publicly announced program, is presented below, in thousands:

Board authorizations:	
July 2008	$60,000
August 2010	60,662
February 2011	65,000
December 2011	50,000
Total amount authorized	235,662
Total value of shares repurchased	214,749
Residual authorization	$20,913

During the nine months ended September 30, 2012, the Company repurchased 1.1 million shares for total consideration of $38.7 million, excluding commissions. The Company repurchased 1.7 million shares for total consideration of $78.1 million, excluding commissions, during the nine months ended September 30, 2011; due to timing, cash payments made for these share repurchases were $77.3 million. As of September 30, 2012, the Company had purchased an aggregate of 4.8 million shares under the program's outstanding authorizations at an average price per share of $44.90 totaling $214.7 million.

10. Acquisitions

Resource Development International Limited
On July 15, 2011, the Company acquired 100% of the share capital of RDI for £7.9 million (approximately $12.6 million), net of cash acquired. RDI is an independent provider of UK university distance learning qualifications and markets, develops and delivers these programs worldwide via its offices and partners across Asia, North America, Africa and Europe. RDI's online distance learning offerings span from degree-entry programs to doctoral level programs and are offered in a variety of disciplines, including business, management, psychology, law, and computing.

As a result of years of investment in its academic infrastructure, RDI has applied to the British Government for TDAP. If awarded, TDAP will enable RDI to independently validate its own degrees going forward under the auspices of the Quality Assurance Agency, a Government body that reviews the standards and quality of all UK universities. Under the terms of the agreement, the Company will make an additional payment of £4.0 million (approximately $6.4 million) if TDAP is granted to RDI. The Company recorded a liability of $5.9 million as of the acquisition date, for the fair value of the TDAP contingent consideration which is included in other liabilities. As the contingent consideration is classified as a liability, ASC 805 requires that the Company re-measure the liability at fair value at each reporting date until it is extinguished. As such, the Company classified the RDI contingent consideration liability within Level 3 of the fair value hierarchy. Refer to Note 6 for discussion of Level 3 fair value measurements.

The Company finalized the purchase accounting in the fourth quarter of 2011 and measured the fair value of the assets acquired and liabilities assumed in accordance with ASC 805. The Company recorded goodwill of $17.0 million, which will be assessed for impairment in the fourth quarter of 2012 as part of the Company's annual impairment review; and capitalized $7.1 million of intangible assets primarily consisting of partner and student relationships, trademark and trade name, learning model, and internally developed software. The estimated useful lives of the intangible assets range from two to ten years. The Company recorded the acquired deferred revenue at its fair value of $1.6 million as of the acquisition date, and assumed net liabilities of approximately $3.9 million in this transaction.

The results of operations of RDI have been included in the Company’s consolidated results of operations since the date of

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acquisition.

Sophia Learning, LLC
The Company acquired a majority ownership interest in Sophia in 2010. The equity interest in Sophia not owned by the Company was reported as noncontrolling interest on the consolidated balance sheet of the Company. Losses incurred by Sophia were charged to the Company and to the noncontrolling interest holder based on ownership percentage. There was a put option within the Sophia Learning, LLC agreement which permitted the noncontrolling interest to put its shares to the Company within a specified time period. Since these shares were outside the control of the Company, the noncontrolling interest was considered contingently redeemable and thus was presented in mezzanine equity in the consolidated balance sheet.

On April 16, 2012, the Company acquired the remaining interest in Sophia for approximately $1.6 million in an arms-length transaction. The Company began accounting for Sophia as a wholly owned subsidiary beginning in the second quarter of 2012 when the noncontrolling interests were acquired.

11. Regulatory Supervision and Oversight

Title IV Compliance Audit of Capella University
Capella University is subject to extensive regulation by federal and state governmental agencies and accrediting bodies. In particular, the Higher Education Act (HEA) and the regulations promulgated thereunder by the Department of Education (DOE) subject the University to significant regulatory scrutiny on the basis of numerous standards that schools must satisfy to participate in the various types of federal learner financial assistance under Title IV Programs.

To participate in the Title IV Programs, an institution must be authorized to offer its programs of instruction by the relevant agencies of the state in which it is located, accredited by an accrediting agency recognized by the DOE and certified as eligible by the DOE. The DOE will certify an institution to participate in the Title IV programs only after the institution has demonstrated compliance with the HEA and the DOE's extensive academic, administrative, and financial regulations regarding institutional eligibility. An institution must also demonstrate its compliance with these requirements to the DOE on an ongoing basis. The University performs periodic reviews of its compliance with the various applicable regulatory requirements. The University has not been notified by any of the various regulatory agencies of any significant noncompliance matters that would adversely impact its ability to participate in Title IV programs, however, the Office of Inspector General (OIG) has conducted a compliance audit of the University. The audit commenced on April 10, 2006 and the University subsequently provided the OIG with periodic information, responded to follow up inquiries and facilitated site visits and access to its records. The OIG completed its fieldwork in January 2007 and the University received a draft audit report on August 23, 2007. The University provided written comments on the draft audit report to the OIG on September 25, 2007. On March 7, 2008, the OIG's final report was issued to the Acting Chief Operating Officer for Federal Student Aid (FSA), which is responsible for primary oversight of the Title IV funding programs. The University responded to the final report on April 8, 2008. The University provided FSA staff with certain additional requested information for financial aid years 2002-2003 through 2007-2008. As the University interpreted the engagement requirement, it estimated for the three year audit period, and for the 2005-2006, 2006-2007 and 2007-2008 financial aid years, the total amount of Title IV funds not returned for learners who withdrew without providing official notification was approximately $1.0 million, including interest, but not including fines and penalties.

On July 2, 2012, the University received a Final Audit Report from FSA. In the Final Audit Report, FSA determined no further action is required on any of the OIG audit findings, other than for the University to adhere to corrective actions already undertaken and communicated to the DOE. The FSA did not require the University to refund any federal student aid funds or pay any fines or penalties. Issuance of the FSA Final Report formally concludes the OIG audit and the reversal of the existing accrual was reflected in the financial statements for the quarter ended June 30, 2012.

Program Review of Capella University

In connection with its administration of the Title IV federal student financial aid programs, the DOE periodically conducts program reviews at selected schools that receive Title IV funds. In April 2012, the DOE notified the University that it will conduct an on-site program review of the University's administration of the Title IV programs. The site visit for the University's program review covered the 2010-2011 and 2011-2012 award years, and took place from May 7 through May 10, 2012. In general, after the DOE conducts its site visit and reviews data supplied by the university, it sends the university a program review report. The University has the opportunity to respond to the findings in the program review report. The DOE then issues a final program review determination letter, which identifies any liabilities. The institution may appeal any monetary liabilities specified in the final program review determination letter. On July 17, 2012, Capella University received an expedited final program review determination letter from the DOE, which did not identify any liabilities and determined no further action is required.

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Political and budgetary concerns significantly affect the Title IV Programs. Congress reauthorizes the HEA and other laws governing Title IV Programs approximately every 5 to 8 years. The last reauthorization of the HEA was completed in August 2008. Additionally, Congress reviews and determines appropriations for Title IV programs on an annual basis through the budget and appropriations processes. As of September 30, 2012, programs in which the University's learners participate are operative and sufficiently funded.

Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations

The following discussion of our historical results of operations and our liquidity and capital resources should be read in conjunction with the consolidated financial statements and related notes that appear elsewhere in this report.

Forward-Looking Statements

Statements contained in this Quarterly Report on Form 10-Q that are not statements of historical fact should be considered forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 (the “Act”). In addition, certain statements in our future filings with the Securities and Exchange Commission (SEC), in press releases, and in oral and written statements made by us or with our approval that are not statements of historical fact constitute forward-looking statements within the meaning of the Act. Examples of forward-looking statements include, but are not limited to, statements regarding: proposed new programs; regulatory developments; projections, predictions, expectations, estimates or forecasts as to our business, financial and operational results and future economic performance; and statements of management’s goals and objectives and other similar expressions concerning matters that are not historical facts. Words such as “may,” “should,” “could,” “would,” “predicts,” “potential,” “continue,” “exp “anticipates,” “future,” “intends,” “plans,” “believes,” “estimates” and similar expressions, as well as statements in future tense intended to identify forward-looking statements, but are not the exclusive means of identifying such statements.

Forward-looking statements involve risks and uncertainties that may cause actual results to differ materially from those in such statements. Factors that could cause actual results to differ from those discussed in the forward-looking statements include, but are not limited to, those described in “Risk Factors” in Part I, Item 1A of our Annual Report on Form 10-K for the fiscal year ended December 31, 2011, as updated in our subsequent reports filed with the SEC, including any updates found in Part II, Item 1A of this or other Quarterly Reports on Form 10-Q. The performance of our business and our securities may be adversely affected by these factors and by other factors common to other businesses and investments, or to the general economy. Forward-looking statements are qualified by some or all of these risk factors. Therefore, you should consider these risk factors with caution and form your own critical and independent conclusions about the likely effect of these risk factors on our future performance. Such forward-looking statements speak only as of the date on which statements are made, and we undertake no obligation to update any forward-looking statement to reflect events or circumstances after the date on which such statement is made to reflect the occurrence of unanticipated events or circumstances. Readers should carefully review the disclosures and the risk factors described in this and other documents we file from time to time with the SEC.

Executive Overview

We are an online postsecondary education services company. As of September 30, 2012, our wholly owned subsidiaries included the following:

- Capella University (the University) is a regionally accredited university offering a variety of undergraduate and graduate degree programs primarily for working adults.
- Resource Development International Limited (RDI) is an independent provider of United Kingdom (UK) university distance learning qualifications and markets, develops and delivers these programs worldwide via its offices and partners across Asia, North America, Africa and Europe.
- Sophia Learning, LLC (Sophia) is a social teaching and learning platform that integrates education with technology.

We believe we have the right operating strategies in place to continually differentiate ourselves in our markets and drive growth by supporting learner success, producing affordable degrees, expanding our comprehensive marketing strategy, and serving a broader set of our learner's professional needs and establishing new growth platforms. Technology and the talent of our faculty and employees enable these strategies. We believe these strategies and enablers will allow us to continue to deliver high quality, affordable education, resulting in continued growth over the long-term. We will continue to invest in these enablers to strengthen the foundation and future of our business.

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Key Trends, Developments and Challenges

The following developments and trends present opportunities, challenges and risks toward achieving our goal of providing attractive returns to our shareholders:

- Initiatives to improve learner success. As we continue to position Capella to drive sustainable growth, we are focused on improving learner success rates particularly in the first four quarters of enrollment, while maintaining a high standard of academic quality and rigor. We have implemented various measures likely to affect our growth and profitability, at least in the near term, including the following:

- Investing in our actionable analytics capabilities to further leverage data, refine our models and accurately predict the likelihood of a prospective and new learner persisting to critical thresholds of success in the learner's first four quarters of enrollment;
- Piloting programs to create personalized pathways for different learner groups which focus on transitioning learners into the online environment, creating a supportive community, and providing a proactive support structure;
- Providing clear information near-real-time to our learners, faculty, advisors and staff to help learners persist and successfully complete their programs;
- Transitioning our marketing approaches to increase emphasis on attracting learners who are more likely to persist in our programs;
- Promoting affordability and encouraging learners to remain enrolled by offering learner success grants to new learners who meet admissions requirements, enroll, and apply within certain timeframes; and,
- Diversifying outside of Capella University by creating innovative new learning technologies that have potential to increase affordability, and better serve the life-long learning needs of working adult professionals and therefore increase learner success.

We have experienced early successes as a result of these initiatives, and overall persistence has increased year over year throughout 2012. Although the early results have been positive, we expect some of these initiatives will adversely impact our new and active enrollment, revenue, and operating margins in the near term. We believe these efforts are in the best interest of our learners and over the long-term will improve learner success and lifetime revenue, which, in turn, positions us for more sustainable long-term growth.

- Comprehensive marketing strategy. Our strategic shift towards a comprehensive marketing strategy which is focused on building relationships with prospective learners early in the decision cycle from a demand driven strategy reinforces our commitment to quality inquiries by:

- Introducing prospective learners to Capella through channels such as mass media and strategic relationships with employers,
- Connecting with prospective learners by generating and nurturing inquiries through direct media such as natural search, our website, and display media, and
- Engaging with prospective learners by developing meaningful relationships such as through social media or direct engagement.

According to our research, the awareness and consideration of Capella University as an educational option has increased compared to the prior year. This shift has also resulted in improved conversion rates of prospective learners. However, inquiry volume has not yet fully replaced previous levels.

We believe our comprehensive marketing strategy will produce long-term efficiencies and increase our ability to attract high-quality learners on a long-term sustainable basis. However, some of these initiatives may adversely impact our new enrollment, revenues, and operating margins in the near term.

- Current market environment. The market continues to present challenging conditions and competition is strong; however, we remain focused on attracting the right learners and learner success. We believe our initiatives to improve learner success through innovation will position us to be a leader in the online post secondary education market.

- Establishing new growth platforms. We seek to drive long-term growth that is an extension of our core competencies

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into new markets. We are pursuing this extension through a small business development team that is exploring early stage opportunities. This may result in increased new business development costs focused on researching, identifying, and cultivating these new opportunities.

In July 2011, we acquired RDI to access the fast-growing international higher education market. RDI has a presence in the UK and certain Commonwealth countries. Although we believe the acquisition will have a positive impact on our revenue growth, there are certain factors that may result in lower than anticipated revenue growth, including regulation changes in the UK Higher Education sector or changes in RDI's university partner relationships. Currently, RDI partners with several universities to validate degrees since RDI does not have its own Taught Degree Awarding Powers. RDI was dilutive to our earnings in the first nine months of 2012, and is expected to be dilutive to our earnings throughout the remainder of 2012 and 2013, in part related to amortization of intangibles and integration expenses.

- New enrollment growth. Although we experienced overall negative new enrollment growth throughout 2011 and in the first half of 2012, we experienced positive new enrollment growth in the third quarter of 2012 led by our master's and certificate programs. The certificate programs were designed with the intent of offering an additional credential or creating a pathway for the learner to ultimately participate in master's or doctoral programs. Certificate programs are shorter in length and generate less revenue per learner than our master's or doctoral programs. Thus, if these learners do not matriculate into a degree program, this may result in a lower learner lifetime value, impacting revenue and operating margins.

- Introduction of new programs and specializations and current program updates. In the first nine months of 2012, we introduced four new degree programs and thirty-one new specializations; in 2011, we launched three new degree programs and fourteen new specializations. We expect to continue to introduce additional degree programs and specializations across our markets in the future, and enhance our current offerings, as we believe this will further position Capella for long-term success. Certain types of new programs or specializations may require Department of Education (DOE or Department) notification and/or approval, which could have an impact on the anticipated timeframe to launch new offerings.

We invest in program and specialization development, as well as support infrastructure and marketing and selling, when introducing new programs and specializations. During the period of new program and specialization introduction, the associated revenues and operating income may grow at a slower rate than our established programs. As our newer programs and specializations develop, we anticipate increases in enrollment, more cost-effective delivery of instructional and support services and more efficient marketing and promotional processes.

Regulatory Environment

The following highlights current developments and trends in our regulatory environment. The complete description of our regulatory environment is presented in our Annual Report on Form 10-K for the fiscal year ended December 31, 2011.

- U.S. Pending Legislation and Congressional Hearings. In recent years, there has been increased focus by members of the U.S. Congress on the role that proprietary educational institutions play in higher education. Congressional hearings and roundtable discussions have been held, and more are expected to be held in the future, regarding various aspects of the education industry including federal financial aid and military education funding that may result in regulatory changes that affect our business. We have voluntarily provided substantial amounts of information about our business at the request of various Congressional committees and individual members, and we intend to continue being responsive to Congress in this regard. On July 30, 2012, Senator Tom Harkin released a final staff report summarizing two years of investigations with regard to proprietary institutions.

The report opens with general statements about the sector and then provides a profile on each of the 30 companies that complied with Harkin's data request from 2010. Within each company profile, the report covered federal revenue, spending, compensation, tuition and academic charges, recruiting, outcomes, retention, student loan defaults, instruction and academics, and staffing. Capella University received positive recognition regarding graduate program outcomes, low cohort default rates, and spending on student services. The report was negative toward Capella University with respect to retention in our bachelor programs and marketing spending. Regarding Capella University's bachelors programs, the data Harkin uses for the report is three to five years old. Over the last two years, we have invested significant time and resources into supporting all of our learners, especially in our bachelors programs. With regard to marketing spending, Capella University has made significant changes in an effort to adjust our marketing model, and as of September 30, 2012, year to date marketing expenses as a percent of revenue remain consistent with

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the prior year. Overall, we are pleased the Harkin report acknowledged the value in Capella's graduate programs which represent roughly 80% of our learner population.

In August 2011, President Obama signed into law the Budget Control Act of 2011, which provides for an increase in the federal government borrowing limit and spending reductions in two phases. The first phase imposes various spending cuts, including the elimination of the partial in-school interest subsidy for graduate student loans beginning July 1, 2012. The cost of borrowing will increase for graduate students who defer payment of interest while enrolled, which could adversely impact enrollment. The second phase would require Congress to develop legislation to achieve future deficit reduction. The outcome of this process is highly uncertain. If Congress does not achieve the required level of deficit reduction, an across-the-board cutting mechanism known as sequestration will take effect beginning with the federal fiscal year 2013. Although the Pell Grant program currently is exempt from the sequestration process, other federal programs and services that could impact our business would be included.

As Congress addresses the historic U.S. budget deficit, financial aid programs are a potential target for reduction. In February 2012, President Obama submitted his fiscal year 2013 federal budget request. The Administration had a proposal to preserve the 3.4% interest rate on undergraduate subsidized student loans for one additional year as the interest rates were set to double July 1, 2012. This initiative was signed into law on July 6, 2012.

The following items in the President's fiscal year 2013 federal budget request are still pending. If enacted, the President's budget request would, among other things:

- Fund a maximum Pell Grant of $5,635 for the 2013-2014 award year, an $85 increase over the prior year; and,
- Make permanent the American Opportunity Tax Credit, which is a refundable tax credit for undergraduate education expenses.

Congress will consider the President's budget request in its formulation of tax and spending legislation later this year, including the fiscal year 2013 appropriations bills that will set specific funding levels for federal education programs. Any action by Congress that significantly reduces Title IV program funding, whether through across-the-board funding reductions, sequestration or otherwise, or materially impacts the eligibility of our institution or students to participate in Title IV programs, would have a material adverse effect on our enrollment, financial condition, results of operations and cash flows.

If Congress significantly reduced the amount of available Title IV program funding, we would attempt to arrange for alternative sources of financial aid for our students; however, private sources would not be able to provide as much funding to our students on as favorable terms as is currently provided by Title IV. In addition, private organizations could require us to guarantee all or part of this assistance and we might incur other additional costs. For these reasons, private, alternative sources of student financial aid would only partly offset the impact on our business of reduced Title IV program funding.

On April 18, 2012, Senators Kay Hagan and Tom Harkin introduced new legislation that would prohibit all colleges and universities from using federal education dollars to pay for marketing, advertising, and recruiting. The Protecting Financial Aid for Students and Taxpayers Act would prohibit the use of Pell Grants, federal student loans, the Post-9/11 G.I. Bill, and other federal education funds for such practices. The language from this bill was inserted into Senator Harkin's Appropriations subcommittee bill and was subsequently adopted by the full Appropriations committee on June 14, 2012. We do not expect further action on this issue until early next year.

- Rulemaking by the U.S. Department of Education. In 2010, the DOE issued new Title IV program integrity rules that address numerous topics. The most significant to our business are the following:

- Adoption of a definition of “gainful employment” for purposes of the requirement for Title IV student financial aid that a program of study offered by a proprietary institution prepare learners for gainful employment in a recognized occupation;
- Implementation of standards for state authorization of institutions of higher education;
- Implementation of standards around the new program approval section of gainful employment; and
- Expansion of the definition of misrepresentation, relating to the Department's authority to suspend or terminate an institution's participation in Title IV programs if the institution engages in substantial

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misrepresentation about the nature of its educational program, its financial charges, or the employability of its graduates, and expansion of the sanctions that the Department may impose for engaging in a substantial misrepresentation.

The Department published final regulations on October 29, 2010, including disclosure and reporting provisions related to gainful employment metrics. Most of the October 29, 2010 final rules were effective July 1, 2011; however, the Department published final gainful employment debt and repayment metrics, and new program approval requirements on June 2, 2011, with an effective date of July 1, 2012. On June 21, 2012, the DOE released data to educational institutions showing the calculation of gainful employment metrics for 2011 for each of the institution's covered programs. This gainful employment information was released to the public on June 26, 2012. An institution's programs must pass a loan repayment rate test or meet debt-to-discretionary income or debt-to-annual earnings ratios in order to remain eligible for federal financial aid. These 2011 metrics were released for informational purposes only, and as pursuant to the Department's final rule published in June 2011, the standards to determine whether a program prepares students for gainful employment went into effect on July 1, 2012. The informational metrics for 2011 are generally based on data reported for Capella University learners and programs from federal Fiscal Years 2007 and 2008.

As a result of a data transmission issue, there is an error in the debt data that the Department used to calculate Capella University's debt-to-discretionary income and debt-to-annual earnings ratios. The error produced more favorable debt-to-earnings metrics than we had anticipated. We thus are unable to rely on the accuracy of the informational debt-to-earnings metrics provided by the Department and have engaged with the Department on this issue. We are not aware of any similar data issues with respect to the loan repayment rate. Six of Capella University's programs did not satisfy the loan repayment rate standard, of which three programs do not have a sufficient number of graduates within the pertinent timeframe to be evaluated. The size of the remaining three programs is not material to the total number of Capella University learners.

On June 30, 2012, one day before the regulation was scheduled to take legal effect, the U.S. District Court for the District of Columbia vacated the Gainful Employment “debt measures” regulation in its entirety, largely on grounds that the loan repayment rate aspect of the regulations was arbitrary and capricious. Although the District Court vacated the debt measures regulation - including the loan repayment and debt-to-income metrics promulgated by the Department to assess whether a program prepared students for gainful employment - and the related institutional reporting requirements and new program approval regulations, the Gainful Employment program disclosure requirements that took effect July 1, 2011 were left intact. On July 30, 2012 the Department filed a motion with the District Court to reinstate the requirement that institutions report data related to the regulation's debt measures. The Department's motion is still pending.

Because of the significance of this regulation, and the basis on which the District Court made its decision, we believe the Department may appeal the full decision to the U.S. Court of Appeals for the District of Columbia Circuit. Further, the District Court found that the Department did possess statutory authority to define “gainful employment” by regulation and to develop specific metrics as part of such regulations. The court's decision, however, means that the Gainful Employment Debt Measures regulation did not take effect on July 1, 2012.

Minnesota Office of Higher Education Cumulative Student Debt Information Request. The Minnesota Office of Higher Education (MOHE) is developing state level metrics related to Average Cumulative Student Loan Debt. The data request was sent to all schools located within the state. The final report will be published by institution and sector (public 2-year, public 4-year, private not-for-profit, and private for-profit) covering average cumulative educational loan debt (excluding PLUS loans) of certificate/degree recipients by award level for 2009-2010. The student loan debt is debt from all sources (federal, state, institution, private) known to the institution. We are working with MOHE on this request. The date for the report to be published has not been determined.

Student Loan Cohort Default Rates. To remain eligible to participate in Title IV programs, an educational institution's student loan cohort default rates must remain below certain specified levels. Under current regulations, an educational institution will lose its eligibility to participate in Title IV programs if its two-year measuring period student loan cohort default rate equals or exceeds 25% for three consecutive cohort years, or 40% for any given year. Capella University's two-year cohort default rates for the 2010 and 2009 cohorts are 7.0% and 6.6%, respectively.

The cohort default rate requirements were modified by the Higher Education Opportunity Act enacted in

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August 2008 to increase by one year the measuring period for each cohort. Starting in September 2012, the Department will publish the official three-year cohort default rates in addition to the two-year rates, beginning with the 2009 cohort. If an institution's three-year cohort default rate exceeds 30% for three consecutive years (compared to 25% under the current two-year standard), it must establish a default prevention task force and develop a default prevention plan with measurable objectives for improving the cohort default rate. We believe that our current repayment management efforts meet these requirements.

If an institution's three-year cohort default rates for the 2009 and 2010 cohorts exceed 30%, the institution may be subject to provisional certification imposing various additional requirements for participation in Title IV programs. Beginning with the three-year cohort default rate for the 2011 cohort published in September 2014, the three-year rates will be applied for purposes of measuring compliance with the requirements. If the three-year cohort default rate for the 2011 cohort exceeds 40%, the institution will cease to be eligible to participate in Title IV programs, and if the institution's three-year cohort default rate exceeds 30% for three consecutive years, beginning with the 2009 cohort, the institution will cease to be eligible to participate in Title IV programs. The Department has published, for informational purposes, “trial rates” to assist institutions in understanding the impact of the new three-year cohort default rate calculation. Capella University's three-year cohort default rate for the 2009 cohort is 9.7%, and its trial three-year cohort default rate for the 2008 cohort is 6.5%. This increase is primarily due to the overall economic environment, and an increased percentage of Capella University learners enrolled in a bachelors program, who generally have a higher default rate compared to graduate learners.

Critical Accounting Policies and Use of Estimates

Our critical accounting policies are disclosed in our Annual Report on Form 10-K for the fiscal year ended December 31, 2011. During the nine months ended September 30, 2012, there have been no significant changes to our critical accounting policies.

Results of Operations

Three Months Ended September 30, 2012 Compared to Three Months Ended September 30, 2011

The following selected financial data table should be referenced in connection with a review of the discussion of our results of operations for the three months ended September 30, 2012:

	Three Months Ended September 30, $ (in thousands, unaudited)		$ Change	% Change	% of Revenue		
	2012	2011	2012 vs. 2011		2012	2011	2012 vs. 2011
Revenues	$99,309	$102,306	$(2,997)	(2.9)%	100.0%	100.0%	0.0%
Costs and expenses:							
Instructional costs and services	44,398	42,523	1,875	4.4	44.7	41.6	3.1
Marketing and promotional	32,964	33,673	(709)	(2.1)	33.2	32.9	0.3
General and administrative	13,664	11,253	2,411	21.4	13.8	11.0	2.8
Total costs and expenses	91,026	87,449	3,577	4.1	91.7	85.5	6.2
Operating income	8,283	14,857	(6,574)	(44.2)	8.3	14.5	(6.2)
Other income (expense), net	(21)	477	(498)	(104.4)	—	0.5	(0.5)
Income before income taxes	8,262	15,334	(7,072)	(46.1)	8.3	15.0	(6.7)

Income tax expense	3,139	5,549	(2,410)	(43.4)	3.2	5.4	(2.2)
Effective tax rate	38.0 %	36.2 %					
Net income	5,123	9,785	(4,662)	(47.6)	5.1	9.6	(4.5)
Net loss attributable to noncontrolling interest	—	149	(149)	(100.0)	—	0.1	(0.1)
Net income attributable to Capella Education Company	$5,123	$9,934	$(4,811)	(48.4)%	5.1 %	9.7 %	(4.6)%

Revenues. The decrease in revenues compared to the same quarter in the prior year is primarily related to a 2.1 percent decrease in total Capella University enrollments at September 30, 2012 compared to the same period in 2011, a larger

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proportion of bachelors and certificate learners who generate less revenue per learner than our masters or doctoral programs, and an increase in tuition grants to support our initiatives to improve learner success. This decrease is slightly offset by the addition of RDI which was acquired in the third quarter of 2011, and price increases. Capella University tuition increases in 2012 averaged approximately two percent and were implemented in July 2012.

Instructional costs and services expenses. Instructional costs and services expenses, and instructional costs and services expenses as a percent of revenue, increased compared to the same quarter in the prior year primarily due to the addition of RDI, which was acquired in the third quarter of 2011, continued investment in strategic initiatives, and an increase in depreciation expense as a result of increased capital investments related to the learner experience and academic quality made throughout 2011 and 2012.

Marketing and promotional expenses. Marketing and promotional expenses decreased compared to the same quarter in the prior year primarily due to decreased reliance on online aggregators as we continue to shift towards a more comprehensive marketing strategy, which focuses on improving conversion rates and new enrollment growth, and also due to employee attrition. These decreases were partially offset by the addition of RDI which was acquired in the third quarter of 2011, as well as continued investment in strategic initiatives.

General and administrative expenses. General and administrative expenses, and general and administrative expenses as a percent of revenue, increased compared to the same quarter in the prior year primarily as a result of increased bad debt expense due to the Title IV program integrity rules which resulted in higher accounts receivable balances and higher reserve percentages. General and administrative expenses also increased due to the addition of RDI which was acquired in the third quarter of 2011.

Other income (expense), net. Other income (expense), net was $21 thousand of expense for the three months ended September 30, 2012, and $0.5 million of income for the three months ended September 30, 2011. The fluctuation compared to the same quarter in the prior year was primarily due to reduced interest income levels as a result of a lower average marketable securities balance in 2012, and expenses related to the credit facility which was entered into during the third quarter of 2011.

Income tax expense. The increase in our effective tax rate compared to the same quarter in the prior year was primarily due to foreign losses for which we receive a lower tax benefit and a decrease in the favorable impact of tax exempt interest due to lower levels of tax exempt investments.

Net income. Net income decreased due to the factors discussed above.

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Nine Months Ended September 30, 2012 Compared to Nine Months Ended September 30, 2011
The following selected financial data table should be referenced in connection with a review of the discussion of our results of operations for the nine months ended September 30, 2012:

	Nine Months Ended September 30, $ (in thousands, unaudited)		$ Change	% Change	% of Revenue		
	2012	2011	2012 vs. 2011		2012	2011	2012 vs. 2011
Revenues	$314,889	$320,061	$(5,172)	(1.6)%	100.0%	100.0%	0.0%
Costs and expenses:							
Instructional costs and services	136,190	127,528	8,662	6.8	43.3	39.8	3.5
Marketing and promotional	98,537	99,812	(1,275)	(1.3)	31.3	31.2	0.1
General and administrative	35,886	29,631	6,255	21.1	11.4	9.3	2.1
Reduction of workforce	—	1,862	(1,862)	(100.0)	—	0.6	(0.6)
Total costs and expenses	270,613	258,833	11,780	4.6	85.9	80.9	5.1
Operating income	44,276	61,228	(16,952)	(27.7)	14.1	19.1	(5.0)
Other income (expense), net	(4)	1,474	(1,478)	(100.3)	—	0.5	(0.5)
Income before income taxes	44,272	62,702	(18,430)	(29.4)	14.1	19.6	(5.5)
Income tax expense	16,630	23,037	(6,407)	(27.8)	5.3	7.2	(1.9)
Effective tax rate	37.6%	36.7%					
Net income	27,642	39,665	(12,023)	(30.3)	8.8	12.4	(3.6)
Net loss attributable to noncontrolling interest	186	394	(208)	(52.8)	0.1	0.1	—
Net income attributable to Capella Education Company	$27,828	$40,059	$(12,231)	(30.5)%	8.9%	12.5%	(3.6)%

Revenues. The decrease in revenues compared to the same period in the prior year is primarily related to a 2.1 percent decrease in total Capella University enrollments at September 30, 2012 compared to the same period in 2011, a larger proportion of bachelors and certificate learners who generate less revenue per learner than our masters or doctoral programs, and an increase in tuition grants to support our initiatives to improve learner success. This decrease is slightly offset by the addition of RDI which was acquired in the third quarter of 2011, and price increases. Capella University tuition increases in 2012 averaged approximately two percent and were implemented in July 2012.
Instructional costs and services expenses. Instructional costs and services expenses, and instructional costs and services as a percent of revenue, increased compared to the same period in the prior year primarily due to the addition of RDI which was acquired in the third quarter of 2011, continued investment in strategic initiatives, an increase in depreciation expense as a result of increased capital investments related to the learner experience and academic quality made throughout 2011 and 2012, and the impairment of property and equipment in the first quarter of 2012.
Marketing and promotional expenses. Marketing and promotional expenses decreased compared to the same period in the prior year primarily due to decreased reliance on online aggregators as we continue to shift towards a more comprehensive marketing strategy, which focuses on improving conversion rates and new enrollment growth, and also due to employee attrition. These decreases were partially offset by the addition of RDI which was acquired in the third quarter of 2011, as well as continued investment in strategic initiatives.

General and administrative expenses. General and administrative expenses, and general and administrative expenses as a percent of revenue, increased compared to the same period in the prior year primarily due to increased bad debt expense as a result of increased bad debt expense due to the Title IV program integrity rules which resulted in higher accounts receivable balances and higher reserve percentages. General and administrative expenses also increased due to the addition of RDI which was acquired in the third quarter of 2011.

This increase was slightly offset by a decrease in estimated bonus expense, and the reversal of the OIG audit accrual in the second quarter. Our estimated total amount of Title IV funds not returned for learners who withdrew without providing official notification was approximately $1.0 million, including interest, but not including fines and penalties.

Reduction of workforce expenses. In February 2011, we implemented a strategic reduction of workforce by eliminating approximately 120 positions and incurring an expense of approximately $1.9 million in the nine months ended September 30, 2011.
Other income (expense), net. Other income (expense), net was $4 thousand of expense for the nine months ended September 30, 2012, and $1.5 million of income for the nine months ended September 30, 2011. The fluctuation compared to the same period in the prior year was primarily due to reduced interest income levels as a result of a lower average marketable securities balance in 2012, increased expenses related to the accretion of the RDI contingent consideration to its fair value, and expenses related to the credit facility which was entered into during the third quarter of 2011.
Income tax expense. The increase in our effective tax rate compared to the same period in the prior year was primarily due to foreign losses for which we receive a lower tax benefit and a decrease in the favorable impact of tax exempt interest due to lower levels of tax exempt investments.
Net income. Net income decreased due to the factors discussed above.

Liquidity and Capital Resources

Liquidity
We financed our operating activities and capital expenditures during the nine months ended September 30, 2012 and 2011 primarily through cash provided by operating activities. Our cash, cash equivalents and marketable securities were $117.4 million and $127.0 million at September 30, 2012 and December 31, 2011, respectively. The decrease in our cash, cash equivalents and marketable securities is primarily a result of lower net income and general business activities.

On September 30, 2011, we entered into an unsecured revolving credit agreement (the Credit Agreement) with Bank of America, N.A., and certain other lenders. The Credit Agreement provides $100.0 million of borrowing capacity, with an increase option of an additional $50.0 million. The Credit Agreement term ends September 30, 2016. As of September 30, 2012, there were no borrowings under the credit facility and we were in compliance with all debt covenants.

Significant portions of our revenues are derived from Title IV programs. Federal regulations dictate the timing of disbursements under Title IV programs. Learners must apply for new loans and grants each academic year, which begins July 1. Loan funds are provided through the William D. Ford Direct Loan program in multiple disbursements for each academic year. The disbursements are usually received by the beginning of the third week of the term. These factors, together with the timing of when our learners begin their programs, affect our operating cash flow. Based on current market conditions and recent regulatory or legislative actions, we do not anticipate any significant near-term disruptions in the availability of Title IV funding for our learners.

On July 15, 2011, we acquired 100% of the share capital of RDI for £7.9 million (approximately $12.6 million), net of cash acquired. In connection with the agreement, we will make an additional payment of £4.0 million (approximately $6.4 million) if RDI is granted Taught Degree Awarding Power (TDAP).

Based on our current level of operations and anticipated growth, we believe our cash provided by operations and other sources of liquidity, including cash, cash equivalents and marketable securities, will provide adequate funds for ongoing operations and planned capital expenditures for the foreseeable future. We can further supplement our liquidity position with the $100.0 million credit facility to fund our operations or to fund strategic investments, if needed.

Operating Activities

Net cash provided by operating activities was $48.7 million and $55.7 million for the nine months ended September 30, 2012 and 2011, respectively. The decrease was primarily a result of lower net income.

Investing Activities

Net cash used in investing activities is primarily related to the purchase or maturity of investments in marketable securities and investments in property and equipment. Net cash provided by (used in) investing activities was $26.8 million for the nine months ended September 30, 2012 and $(5.5) million for the nine months ended September 30, 2011. Cash provided from marketable securities consisted of maturities of these tax-exempt investments. Net purchases and maturities of marketable securities were $46.0 million and $27.2 million during the nine months ended September 30, 2012 and 2011, respectively. The maturities of marketable securities in 2012 were primarily held as cash and cash equivalents at September 30, 2012.

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We believe the credit quality and liquidity of our investment portfolio as of September 30, 2012 is strong. The unrealized gains and losses of the portfolio may remain volatile as changes in the general interest rate environment and supply/demand fluctuations of the securities within our portfolio impact daily market valuations. To mitigate the risk associated with this market volatility, we deploy a relatively conservative investment strategy focused on capital preservation and liquidity. But even with this approach, we may incur investment losses as a result of unusual and unpredictable market developments and we may experience reduced investment earnings if the yields on investments deemed to be low risk remain low or decline further due to unpredictable market developments. In addition, these unusual and unpredictable market developments may also create liquidity challenges for certain of the assets in our investment portfolio.

Capital expenditures were $18.0 million and $20.0 million for the nine months ended September 30, 2012 and 2011, respectively, and primarily consisted of investments in software related to learner success and academic quality. The decrease in 2012 compared to the same period in the prior year was primarily due to our 2011 investment in a data center.

We lease all of our facilities. We expect to make future payments on existing leases from cash generated from operations.

Financing Activities

Net cash used in financing activities was $38.1 million and $75.6 million for the nine months ended September 30, 2012 and 2011, respectively. The decrease in net cash used is the result of a reduction in repurchases of our common stock. In the first nine months of 2012, we repurchased $38.7 million of common stock under our repurchase program, excluding commissions. In the first nine months of 2011 we repurchased $78.1 million of common stock, excluding commissions; due to timing, cash paid for repurchases in the first nine months of 2011 was $77.3 million.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Market Risk

The Company has no derivative financial instruments or derivative commodity instruments, and believes the risk related to cash equivalents and marketable securities is limited due to the adherence to its investment policy, which focuses on capital preservation and liquidity. In addition, all investments must have a minimum Standard & Poor’s rating of A minus (or equivalent) by at least one agency at the purchase date. All of the Company's cash equivalents and marketable securities as of September 30, 2012 and December 31, 2011 were rated A minus or higher by at least one rating agency. In addition, the Company utilizes money managers who conduct initial and ongoing credit analysis on its investment portfolio to monitor and minimize the potential impact of market risk associated with its cash, cash equivalents and marketable securities. Despite the investment risk mitigation strategies the Company employs, it may incur investment losses as a result of unusual and unpredictable market developments and may experience reduced investment earnings if the yields on investments deemed to be low risk remain low or decline further in this time of economic uncertainty. Unusual and unpredictable market developments may also create liquidity challenges for certain assets in the Company's investment portfolio.

Interest Rate Risk

The Company manages interest rate risk by investing excess funds in cash equivalents and marketable securities bearing a combination of fixed and variable interest rates, which are tied to various market indices. The Company's future investment income may fall short of expectations due to changes in interest rates or it may suffer losses in principal if it is forced to sell securities that have declined in market value due to changes in interest rates. At September 30, 2012, a 10% increase or decrease in interest rates would not have a material impact on the Company's future earnings, fair values, or cash flows.

Foreign Currency Exchange Risk

The Company uses the U.S. dollar as its reporting currency. The functional currencies of its foreign subsidiaries are generally the local currencies. Accordingly, the Company's foreign currency exchange risk is related to the following exposures:

- Adjustments resulting from the translation of assets and liabilities of the foreign subsidiaries into U.S. dollars using exchange rates in effect at the balance sheet dates. These translation adjustments are recorded in accumulated other comprehensive income;
- Earnings volatility translation of income and expense items of the foreign subsidiaries using an average monthly exchange rate for the respective periods; and
- Gains and losses resulting from foreign exchange rate changes related to intercompany receivables and payables that are not of a long-term investment nature, as well as gains and losses from foreign currency transactions. These items are recorded in other income, net in the Consolidated Statements of Income.

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The Company has not used derivative contracts to hedge foreign currency exchange rate fluctuations.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

The Company carried out an evaluation, under the supervision and with the participation of its management, including the chief executive officer and the chief financial officer, of the effectiveness of the design and operation of its disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act).

Based upon that evaluation, the chief executive officer and chief financial officer concluded that the Company’s disclosure controls and procedures were effective, as of September 30, 2012, in ensuring that material information required to be disclosed by the Company in reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by an issuer in reports it files or submits under the Securities Exchange Act is accumulated and communicated to management, including its principal executive officer or officers and principal financial officer or officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

Changes in Internal Control over Financial Reporting

There was no change in the Company's internal control over financial reporting identified in connection with the evaluation required by Rule 13a-15(d) and 15d-15(d) of the Exchange Act that occurred during the period covered by this report that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

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PART II - OTHER INFORMATION

Item 1. Legal Proceedings

From time to time, the Company is a party to various lawsuits, claims and other legal proceedings that arise in the ordinary course of business. While the outcomes of these matters are uncertain, management does not expect that the ultimate costs to resolve these matters will have a material adverse effect on the Company's consolidated financial position, results of operations or cash flows.

Item 1A. Risk Factors

There have been no material changes to the risk factors disclosed in the “Risk Factors” section as updated in the Company's Form 10-K for the year ended December 31, 2011.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

Recent Sales of Unregistered Securities
None.

Purchases of Equity Securities by the Issuer and Affiliated Purchasers
During the three months ended September 30, 2012, the Company used $13.3 million to repurchase shares of common stock under its repurchase program.(1) Its remaining authorization for common stock repurchases was $20.9 million at September 30, 2012. The following presents the Company's share repurchases during the quarter ended September 30, 2012:

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Dollar Value of Shares That May Yet be Purchased Under the Plans or Programs
7/1/2012 to 7/31/2012	160,801	$ 29.99	160,801	$ 29,353,784
8/1/2012 to 8/31/2012	167,378	31.27	167,378	24,119,263
9/1/2012 to 9/30/2012	94,159	34.05	94,159	20,913,091
Total	422,338	31.40	422,338	20,913,091

(1) The Company announced its current share repurchase program in July 2008. As of September 30, 2012, the Company's Board of Directors has authorized repurchases up to an aggregate amount of $235.7 million in value of common stock under the current program. The Board of Directors authorizes the Company to repurchase outstanding shares of common stock, from time to time, depending on market conditions and other considerations. There is no expiration date on the repurchase authorizations and repurchases occur at the Company's discretion.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

None.

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Item 6. Exhibits
(a) Exhibits

Number	Description	Method of Filing
3.1	Amended and Restated Articles of Incorporation.	Incorporated by reference to Exhibit 3.1 to the Company’s Current Report on Form 8-K filed with the SEC on November 11, 2006.
3.2	Second Amended and Restated By-Laws.	Incorporated by reference to Exhibit 3.2 to the Company's Current Report on Form 8-K filed with the SEC on December 10, 2008.
4.1	Specimen of common stock certificate.	Incorporated by reference to Exhibit 4.1 to Amendment No. 4 to the Company’s Registration Statement on Form S-1 filed with the SEC on October 19, 2006.
31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.	Filed electronically.
31.2	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.	Filed electronically.
32.1	Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.	Filed electronically.
32.2	Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.	Filed electronically.
EX-101.INS	XBRL Instance Document(1)	Filed electronically.
EX-101.SCH	XBRL Taxonomy Extension Schema Document(1)	Filed electronically.
EX-101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document(1)	Filed electronically.
EX-101.DEF	XBRL Taxonomy Extension Definition Linkbase Document(1)	Filed electronically.
EX-101.LAB	XBRL Taxonomy Extension Label Linkbase Document(1)	Filed electronically.

EX-101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document[1]	Filed electronically.

(1) The XBRL related information in Exhibit 101 to this Quarterly Report on Form 10-Q shall not be deemed “filed” for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, or otherwise subject to liability of that section and shall not be incorporated by reference into any filing or other document pursuant to the Securities Act of 1933, as amended, except as shall be expressly set forth by specific reference in such filing or document.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

CAPELLA EDUCATION COMPANY

/s/ J. Kevin Gilligan
October 23, 2012
J. Kevin Gilligan
Chief Executive Officer
(Principal Executive Officer)

/s/ Steven L. Polacek
October 23, 2012
Steven L. Polacek
Senior Vice President and Chief Financial Officer
(Principal Financial and Accounting Officer)