

CAPELLA EDUCATION CO  
Form 10-Q  
October 28, 2014  
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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

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FORM 10-Q

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(Mark One)

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

For the quarterly period ended September 30, 2014  
or

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

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

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Minnesota 41-1717955  
(State or other jurisdiction of (I.R.S. Employer  
incorporation or organization) Identification No.)

Capella Tower 55402  
225 South Sixth Street, 9<sup>th</sup> Floor (Zip Code)  
Minneapolis, Minnesota  
(Address of principal executive offices)

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

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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  No

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  No

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.

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Large accelerated filer	<input type="radio"/>	Accelerated filer	<input checked="" type="checkbox"/>
Non-accelerated filer	<input type="radio"/> (Do not check if a smaller reporting company)	Smaller reporting company	<input type="checkbox"/>

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

The total number of shares of common stock outstanding as of October 23, 2014 was 12,230,515.

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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, 2014 (Unaudited)	As of December 31, 2013
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$90,451	\$124,097
Marketable securities, current	36,258	18,342
Accounts receivable, net of allowance of \$6,719 at September 30, 2014 and \$7,091 at December 31, 2013	17,006	16,919
Prepaid expenses and other current assets	11,033	10,548
Deferred income taxes	2,809	2,846
Total current assets	157,557	172,752
Marketable securities, non-current	33,583	17,740
Property and equipment, net	37,728	39,993
Goodwill	17,106	16,969
Intangibles, net	2,062	2,795
Other assets	1,453	—
Total assets	\$249,489	\$250,249
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$5,090	\$7,939
Accrued liabilities	29,041	33,164
Dividends payable	4,365	4,346
Deferred revenue	12,469	10,736
Total current liabilities	50,965	56,185
Deferred rent	2,598	3,221
Other liabilities	3,190	2,541
Deferred income taxes	5,674	6,283
Total liabilities	62,427	68,230
Shareholders' equity:		
Common stock, \$0.01 par value: Authorized shares — 100,000; Issued and Outstanding shares — 12,250 at September 30, 2014 and 12,361 at December 31, 2013	122	124
Additional paid-in capital	109,679	104,546
Accumulated other comprehensive loss	(473	) (114
Retained earnings	77,734	77,463
Total shareholders' equity	187,062	182,019
Total liabilities and shareholders' equity	\$249,489	\$250,249

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, 2014		2013		Nine Months Ended September 30, 2014		2013	
	(Unaudited)							
Revenues	\$103,097	\$100,703	\$313,525	\$309,638				
Costs and expenses:								
Instructional costs and services	47,143	45,984	139,973	137,851				
Marketing and promotional	25,509	26,489	74,383	76,091				
Admissions advisory	7,019	6,796	21,092	20,294				
General and administrative	10,250	10,924	31,604	32,252				
Lease amendment charges	—	—	2,690	—				
Total costs and expenses	89,921	90,193	269,742	266,488				
Operating income	13,176	10,510	43,783	43,150				
Other expense, net	(46	) (238	) (559	) (463				)
Income before income taxes	13,130	10,272	43,224	42,687				
Income tax expense	5,373	4,262	17,606	17,500				
Net income	\$7,757	\$6,010	\$25,618	\$25,187				
Net income per common share:								
Basic	\$0.63	\$0.48	\$2.08	\$2.03				
Diluted	\$0.62	\$0.48	\$2.04	\$2.01				
Weighted average number of common shares outstanding:								
Basic	12,268	12,394	12,301	12,394				
Diluted	12,505	12,591	12,545	12,522				
Cash dividends declared per common share	\$0.35	\$—	\$1.05	\$—				

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, 2014		2013		Nine Months Ended September 30, 2014		2013	
Net income	\$7,757		\$6,010		\$25,618		\$25,187	
Other comprehensive income (loss):								
Foreign currency translation gain (loss)	137		97		(367		) 285	
Unrealized gains (losses) on available for sale securities, net of tax	(9		) 34		8		13	
Comprehensive income	\$7,885		\$6,141		\$25,259		\$25,485	

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	
	2014	2013
	(Unaudited)	
Operating activities		
Net income	\$25,618	\$25,187
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for bad debts	11,232	11,225
Depreciation and amortization	18,016	19,717
Amortization of investment discount/premium	1,319	540
Impairment of property and equipment	277	229
Loss on disposal of property and equipment	77	46
Share-based compensation	3,927	3,991
Excess tax benefits from share-based compensation	(451)	(134)
Deferred income taxes	(537)	(242)
Payment of contingent consideration	(906)	—
Changes in operating assets and liabilities:		
Accounts receivable	(11,273)	(11,519)
Prepaid expenses and other current assets	(670)	(1,006)
Accounts payable and accrued liabilities	(230)	6,863
Income taxes payable	149	(2,536)
Deferred rent	(623)	(795)
Deferred revenue	1,548	1,622
Net cash provided by operating activities	47,473	53,188
Investing activities		
Capital expenditures	(15,788)	(14,801)
Investment in partnership interest	(1,453)	—
Purchases of marketable securities	(48,957)	(22,426)
Maturities of marketable securities	13,890	7,635
Net cash used in investing activities	(52,308)	(29,592)
Financing activities		
Excess tax benefits from share-based compensation	451	134
Net proceeds from exercise of stock options	3,663	2,684
Payment of dividends	(12,961)	—
Repurchases of common stock	(14,032)	(4,808)
Payment of contingent consideration	(5,945)	—
Net cash used in financing activities	(28,824)	(1,990)
Effect of foreign exchange rates on cash	13	(42)
Net increase (decrease) in cash and cash equivalents	(33,646)	21,564
Cash and cash equivalents at beginning of period	124,097	93,220
Cash and cash equivalents at end of period	\$90,451	\$114,784
Supplemental disclosures of cash flow information		
Income taxes paid	\$18,327	\$20,283
Noncash transactions:		
Purchase of equipment included in accounts payable and accrued liabilities	\$425	\$366
Declaration of cash dividend to be paid	\$4,346	\$—

Repurchases of common stock included in accrued liabilities	\$241	\$—
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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), Sophia Learning, LLC (Sophia), and Capella Learning Solutions (CLS). 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. CLS is a subsidiary created in 2013 that provides online training solutions and services to corporate partners which are delivered through Capella's online learning platform. With the Company's focus on academic quality in an online delivery format, it has one reporting segment.

2. Summary of Significant Accounting Policies

Consolidation

The consolidated financial statements include the accounts of the Company, the University, CLS, RDI and its subsidiaries, and Sophia, after elimination of intercompany accounts and transactions. RDI operates on a fiscal year ending October 31, which is also the date used for consolidation.

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, 2013 (2013 Annual Report on Form 10-K).

Certain reclassifications have been made to the accrued liabilities table as of December 31, 2013 in Note 7 to align with current reporting methods.

Refer to the Company's "Summary of Significant Accounting Policies" footnote included within the 2013 Annual Report on Form 10-K for a complete summary of the Company's significant accounting policies.

3. Recent Accounting Pronouncements

In August 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2014-15, Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern, which is included in Accounting Standards Codification (ASC) 205, Presentation of Financial Statements. This update provides an explicit requirement for management to assess an entity's ability to continue as a going concern, and to provide related footnote disclosure in certain circumstances. The guidance will be effective for the Company's annual reporting period beginning January 1, 2017, and applied prospectively; early adoption is also permitted. The Company does not expect adoption of this guidance to have a material impact on its financial condition, results of operations, or disclosures.

In May 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers, which is included in ASC 606, Revenue from Contracts with Customers. This ASU is a comprehensive new revenue recognition model that creates a single source of revenue guidance for all companies in all industries. The model is more principles-based than current guidance, and is

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primarily based on recognizing revenue at an amount that reflects consideration to which the entity expects to be entitled to in exchange for transferring goods or services to a customer. The guidance will be effective for the Company's interim and annual reporting periods beginning January 1, 2017. The standard allows the Company to transition to the new model using either a full or modified retrospective approach, and early adoption is not permitted. The Company is currently evaluating the impact this standard will have on its business practices, financial condition, results of operations, and disclosures.

In March 2013, the FASB issued ASU No. 2013-05, Foreign Currency Matters. This update addresses diversity in practice regarding the release of the cumulative translation adjustment into net income when a parent either sells a part or all of its investments in a foreign entity. In addition, the standard addresses diversity in practice for the treatment of business combinations achieved in stages involving a foreign entity. The guidance was effective for the Company's interim and annual reporting periods beginning January 1, 2014, 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.

In February 2013, the FASB issued ASU No. 2013-02, Reporting of Amounts Reclassified out of Accumulated Other Comprehensive Income, which is included in Accounting Standards Codification (ASC) 220, Comprehensive Income. This update improves the reporting of reclassifications out of accumulated other comprehensive income. The guidance was effective for the Company's interim and annual reporting periods beginning January 1, 2013, 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 other 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 per Common Share

Basic net income 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, settlement of restricted stock, and satisfaction of service conditions for market stock units.

The following table presents a reconciliation of the numerator and denominator in the basic and diluted net income per common share calculation, in thousands, except per share data:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Numerator:				
Net income	\$7,757	\$6,010	\$25,618	\$25,187
Denominator:				
Denominator for basic net income per common share— weighted average shares outstanding	12,268	12,394	12,301	12,394
Effect of dilutive stock options, restricted stock, and market stock units	237	197	244	128
Denominator for diluted net income per common share— weighted average shares outstanding	12,505	12,591	12,545	12,522
Basic net income per common share	\$0.63	\$0.48	\$2.08	\$2.03
Diluted net income per common share	\$0.62	\$0.48	\$2.04	\$2.01

Options to purchase common shares were outstanding, but not included in the computation of diluted net income per common share, because their effect would be anti-dilutive. The following table summarizes these securities, in

thousands:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Anti-dilutive securities excluded from diluted earnings per share calculation	232	323	213	569

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## 5. Marketable Securities

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

	As of September 30, 2014			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Estimated Fair Value
Tax-exempt municipal securities	\$61,097	\$56	\$(9)	) \$61,144
Corporate debt securities	8,686	14	(3)	) 8,697
Total	\$69,783	\$70	\$(12)	) \$69,841

	As of December 31, 2013			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Estimated Fair Value
Tax-exempt municipal securities	\$30,422	\$46	\$—	\$30,468
Corporate debt securities	5,615	3	(4)	) \$5,614
Total	\$36,037	\$49	\$(4)	) \$36,082

The unrealized gains and losses on the Company's investments in municipal and corporate debt securities as of September 30, 2014 and December 31, 2013 were caused by changes in market values primarily due to interest rate changes. All of the Company's securities in an unrealized loss position as of September 30, 2014 had been in an unrealized loss position for less than twelve months. The Company does not intend to sell these securities and it is not more likely than not that the Company will be required to sell these securities prior to the recovery of their amortized cost basis, which may be maturity. No other-than-temporary impairment charges were recorded during the three and nine months ended September 30, 2014 and 2013.

The following table summarizes the remaining contractual maturities of the Company's marketable securities, in thousands:

	As of September 30, 2014	As of December 31, 2013
Due within one year	\$36,258	\$18,342
Due after one year through five years	33,583	17,740
Total	\$69,841	\$36,082

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,	
	2014	2013	2014	2013
Maturities of marketable securities	\$6,915	\$500	\$13,890	\$7,635
Total	\$6,915	\$500	\$13,890	\$7,635

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, 2014 and 2013. Additionally, there were no proceeds from sales of marketable securities prior to maturity during the three and nine months ended September 30, 2014 and 2013.

## 6. Fair Value Measurements

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



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Description	Fair Value Measurements as of September 30, 2014 Using			
	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	\$67,143	\$ 67,143	\$—	\$—
Money market funds	19,928	19,928	—	—
Variable rate demand notes	3,380	3,380	—	—
Marketable securities:				
Tax-exempt municipal securities	61,144	—	61,144	—
Corporate debt securities	8,697	—	8,697	—
Total assets at fair value on a recurring basis:	\$ 160,292	\$ 90,451	\$ 69,841	\$—
Description	Fair Value Measurements as of December 31, 2013 Using			
	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	\$47,796	\$47,796	\$—	\$—
Money market funds	57,066	57,066	—	—
Variable rate demand notes	19,235	19,235	—	—
Marketable securities:				
Tax-exempt municipal securities	30,468	—	30,468	—
Corporate debt securities	\$5,614	—	5,614	—
Total assets at fair value on a recurring basis:	\$ 160,179	\$ 124,097	\$ 36,082	\$—
Liabilities:				
Accrued liabilities:				
RDI contingent consideration	\$6,304	\$—	\$—	\$6,304
Total liabilities at fair value on a recurring basis:	\$ 6,304	\$—	\$—	\$6,304

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 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, 2014 and 2013.

The Company did not have any liabilities requiring fair value measurement as of September 30, 2014.

## Level 3 Measurements

## RDI Contingent Consideration

In connection with the acquisition of RDI, the Company was required to make an additional payment to the former shareholders of RDI when RDI was awarded Taught Degree Awarding Powers (TDAP) by the British government. Refer to Note 12 of the Company's 2013 Annual Report on Form 10-K for additional details regarding the acquisition of RDI.

On April 14, 2014, RDI received notice from the British government that it had successfully been awarded TDAP. 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. Pursuant to the terms of the acquisition

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agreement in 2011, the Company made an additional payment of £4.0 million (approximately \$6.9 million) to the former shareholders of RDI on May 12, 2014.

Prior to payment, the contingent consideration was classified as a liability under ASC 805 Business Combinations (ASC 805), which required the Company to re-measure the liability at fair value at each reporting date until it was extinguished. The Company classified the RDI contingent consideration liability within Level 3 of the fair value measurement hierarchy as its fair value was determined using inputs not readily observable in the market.

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

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2014	2013	2014	2013
Balance, beginning of period	\$—	\$6,186	\$6,304	\$6,252
Increase in RDI contingent consideration liability	—	68	547	2
Payment of RDI contingent consideration liability	—	—	(6,851)	) —
Balance, end of period	\$—	\$6,254	\$—	\$6,254

The change in the fair value of the RDI contingent consideration liability was recorded in other expense, net in the consolidated statements of income during the three and nine months ended September 30, 2014 and 2013. The fair value of the RDI contingent consideration liability was recorded as accrued liabilities in the consolidated balance sheet at December 31, 2013.

The cash payment made to settle the RDI contingent consideration liability is recorded as cash used in operating activities and cash used in financing activities in the consolidated statement of cash flows during the nine months ended September 30, 2014. The portion of the payment recorded as cash used in operating activities represents the accumulated change in fair value of the contingent consideration liability between the acquisition date of July 15, 2011 and the payment date of May 12, 2014, and the portion of the payment recorded as financing activities represents the initial fair value of the liability recorded at the July 15, 2011 acquisition date.

## 7. Accrued Liabilities

Accrued liabilities consist of the following, in thousands:

	As of September 30, 2014	As of December 31, 2013
Accrued compensation and benefits	\$8,189	\$10,333
Accrued instructional	4,577	5,043
Accrued vacation	1,913	1,040
Accrued invoices	9,437	7,240
RDI contingent consideration	—	6,304
Lease amendment <sup>(1)</sup>	2,449	—
Other	2,476	3,204
Total	\$29,041	\$33,164

On April 3, 2014, the Company accepted notice to activate an amendment to its lease with Minneapolis 225 (1)Holdings, LLC, and also consolidated certain of its other leased office space during the nine months ended September 30, 2014. Refer to Note 8 for details of these arrangements.

## 8. Commitments and Contingencies

### Operating Leases

The Company leases its office facilities and certain office equipment under various noncancelable operating leases. Effective August 29, 2011, the Company entered into an amendment of its 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 October 31, 2018. Renewal terms under this lease allow the Company to extend the lease for up to two additional five-year terms.

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On April 3, 2014, the Company accepted notice to activate an amendment to this lease. Pursuant to the amendment, in June 2014, the Company returned 54,940 square feet of its previously leased space of 426,165 square feet. Employees located in this area were relocated to other areas within the Company's remaining space. The Company recorded a charge of approximately \$2.6 million during the nine months ended September 30, 2014 in connection with this amendment, which is included within the lease amendment charge line item of the consolidated statements of income. The Company anticipates expense savings of approximately \$7.0 million through October 31, 2018, with approximately \$0.4 million of those savings expected in the fourth quarter of 2014.

The Company also consolidated certain of its other leased office space which resulted in an additional charge of \$0.1 million during the nine months ended September 30, 2014. This amount is included within the lease amendment charge line item of the consolidated statements of income.

The following presents the Company's future minimum lease commitments as of September 30, 2014, in thousands:

2014	\$ 1,753
2015 <sup>(1)</sup>	8,107
2016	6,186
2017	6,010
2018	4,878
2019 and thereafter	—
Total	\$ 26,934

(1) Includes \$1.9 million lease termination payment related to the April 3, 2014 lease amendment.

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 of rent expense 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.

On January 4, 2012, RDI entered into an agreement to assign its lease in the UK to Glasgow Caledonian University (GCU) for the remainder of the lease term, which expires in May 2020. Under the terms of the agreement, GCU covenants to the lessor that it will pay the remaining rents under the lease term. However, the lessor required that RDI act as guarantor for GCU in the event GCU defaults under the lease. The Company believes default by GCU under the lease, and therefore any future payment by RDI as guarantor to GCU under this arrangement, is remote.

#### 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 the London Interbank Offered Rate (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. The Company recorded commitment fee expenses of

\$0.1 million and \$0.2 million in other expense, net, for the three months ended September 30, 2014 and 2013, and the nine months ended September 30, 2014 and 2013, respectively. 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 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

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September 30, 2014, there were no borrowings under the credit facility, and the Company was in compliance with all debt covenants.

## 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 there are any significant matters as of September 30, 2014 that are probable or estimable, for which the outcome could have a material adverse impact on its consolidated financial position or results of operations.

## 9. Share Repurchase Program and Dividends

## 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, 2014, 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
August 2013	50,000
Total amount authorized	285,662
Total value of shares repurchased	250,606
Residual authorization	\$35,056

The following table summarizes shares repurchased, in thousands:

	Nine Months Ended September 30,	
	2014	2013
Shares repurchased	237	104
Total consideration, excluding commissions	\$14,263	\$4,804

As of September 30, 2014, the Company had purchased an aggregate of 5.6 million shares under the program's outstanding authorizations at an average price per share of \$44.76 totaling \$250.6 million.

## Dividends

During the nine months ended September 30, 2014, the Company declared the following cash dividends, in thousands except per share amounts:

Declaration Date	Record Date	Payment Date	Dividend per Share	Total Dividend Amount
February 20, 2014	March 26, 2014	April 10, 2014	\$0.35	\$4,382
May 6, 2014	June 11, 2014	July 10, 2014	\$0.35	\$4,354
August 7, 2014	September 10, 2014	October 10, 2014	\$0.35	\$4,346

During the three months ended September 30, 2014, the dividend of \$0.35 per outstanding share of common stock declared on August 7, 2014 was recorded as a reduction to retained earnings. Of the total dividend amount, \$4.3

million is attributable to shares of common stock outstanding as of the record date and restricted stock units expected to vest in the next twelve months. This amount is classified as dividends payable in the Company's consolidated balance sheet as of September 30, 2014. The remaining balance is attributable to restricted stock units expected to vest subsequent to the next twelve months and is classified as other liabilities in the Company's consolidated balance sheet as of September 30, 2014. All future dividends are subject to declaration by the Company's Board of Directors and may be adjusted due to future business needs or other factors deemed relevant by the Board of Directors.

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There were no dividends declared or paid during the three and nine months ended September 30, 2013.

## 10. Share-Based Compensation

## Share-Based Incentive Plans

On May 6, 2014, the Company implemented a stock incentive plan (the 2014 Plan) that allows for incentive stock options, non-qualified stock options, stock appreciation rights (SARs), restricted stock awards (RSAs), stock unit awards, and other stock-based awards to be granted to employees, directors, officers, and others. The 2014 Plan authorized the issuance of 480,000 shares of the Company's common stock, plus 830,888 shares that remained available for future grants under the 2005 Stock Incentive Plan (the 2005 Plan) on the effective date of the 2014 Plan. Upon effectiveness of the 2014 Plan, no further awards will be made under the 2005 Plan. As of September 30, 2014, the maximum number of shares of common stock reserved under the 2014 Plan was approximately 1.3 million, of which 1.3 million shares were available for grant.

The Board of Directors establishes the terms and conditions of all grants, subject to the 2014 Plan and applicable provisions of the Internal Revenue Code (the Code). Under the 2014 Plan, options must be granted at an exercise price not less than the fair market value of the Company's common stock on the grant date. The options expire on the date determined by the Board of Directors, but may not extend more than ten years from the grant date. The options generally become exercisable over a four-year period. Restricted stock units (RSUs) generally vest over a three year period. Canceled options and RSUs become available for reissuance under the 2014 Plan. Upon an exercise of stock options, the Company issues new shares.

The Company also has issued stock options under two discontinued plans (the 2005 Plan and the 1999 Plan). Stock options, restricted stock units, and market stock units issued pursuant to the 2005 Plan, and stock options issued pursuant to the 1999 Plan, are still outstanding. However, unexercised options that are canceled upon termination of employment are not available for reissuance under the 2005 or 1999 Plan.

## Share-Based Compensation Expense

The table below reflects the Company's share-based compensation expense recognized in the consolidated statements of income, in thousands:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Instructional costs and services	\$238	\$380	\$546	\$1,141
Marketing and promotional	102	181	149	424
Admissions advisory	14	8	44	34
General and administrative	815	816	3,188	2,392
Share-based compensation expense included in operating income	1,169	1,385	3,927	3,991
Tax benefit from share-based compensation expense	431	510	1,270	1,474
Share-based compensation expense, net of tax	\$738	\$875	\$2,657	\$2,517

Effective in 2014, the Company evaluated the allocation of share-based compensation among its operating expense categories and determined reallocation of expenses related to certain executives and directors was necessary to best align with the Company's organizational structure. Prior to 2014, share-based compensation expense related to awards granted to certain executives and members of the Company's Board of Directors was allocated among all of the Company's operating expense categories. Effective in 2014, the Company is prospectively including all share-based

compensation expense related to awards granted to these individuals as general and administrative.

#### 11. Acquisitions and Other Investments

During the nine months ended September 30, 2014, the Company made a cost method investment of \$1.5 million in a limited partnership, with a commitment to invest up to an additional \$3.5 million over the next ten years. The partnership invests in innovative companies in the health care field. The Company's investment comprises less than 3.0% of the total partnership interest and is classified as other assets in the consolidated balance sheets as of September 30, 2014.

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## 12. Accumulated Other Comprehensive Loss

The following table summarizes the components of accumulated other comprehensive loss, in thousands:

	Foreign Currency Translation Loss	Unrealized Gain on Marketable Securities	Accumulated Other Comprehensive Loss <sup>(1)</sup>
Beginning balance, December 31, 2013	\$(142	) \$28	\$(114 )
Current period change	(367	) 8	(359 )
Ending balance, September 30, 2014	\$(509	) \$36	\$(473 )

(1) Accumulated other comprehensive loss is presented net of tax of \$22 thousand and \$17 thousand as of September 30, 2014 and December 31, 2013, respectively.

There were no reclassifications out of accumulated other comprehensive loss to net income for the three and nine months ended September 30, 2014 and 2013.

## 13. Regulatory Supervision and Oversight

Political and budgetary concerns significantly affect the Title IV Programs. Congress reauthorizes the Higher Education Act (HEA) and other laws governing Title IV Programs approximately every five to eight 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, 2014, programs in which the University's learners participate are operative and sufficiently funded.

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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," "expect," "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, 2013, 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, 2014, our wholly owned subsidiaries included the following:

• Capella University (the University) is a regionally accredited university that offers 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 that 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.

• Capella Learning Solutions (CLS) provides online training solutions and services to corporate partners which are delivered through Capella's online learning platform.

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, optimizing our comprehensive marketing strategy, 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.

**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:

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Enrollment and persistence. New enrollment is an important indicator of revenue growth and Company profitability. Overall, new enrollments grew 11.9 percent in the third quarter of 2014 compared to a 1.3 percent decrease in the same period in 2013. New enrollment is calculated from the last day a new learner can drop a course without financial penalty. New enrollment growth in 2014 was led by our master's programs. Although new enrollment growth is an important metric, the combination of new enrollment and persistence are key drivers for total enrollment and revenue performance. In the third quarter of 2014, we reached a significant milestone by returning to total enrollment growth of 2.1 percent after experiencing total enrollment declines since fiscal year 2011. We are committed to building a sustainable business model focused on total enrollment growth.

Doctoral enrollment. During the third quarter of 2014, year-over-year Doctoral total enrollment declined by 5.4 percent. It will take some time for our Doctoral programs to return to total enrollment growth due to a combination of factors, including the extended decision cycles for prospects at the Doctoral level and stronger Doctoral graduations in 2013 and 2014. We are extending our learner success focus to the comprehensive and dissertation portion of our Doctoral programs. Our goal is to address the learner population that is not making sufficient and timely academic progress in this phase and expect this initiative to create some pressure on our Doctoral enrollments in the near-term. To support the return to Doctoral growth we are focusing on redesigning our program offerings, improving affordability, and expanding our professional doctorate portfolio.

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. While certain initiatives could affect our growth and profitability 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. These initiatives include the following:

- Optimizing and enhancing 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, implementing, and optimizing programs such as assessments and orientations 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 timely and clear information to our learners, faculty, advisors and staff to help learners persist and successfully complete their programs;

- Optimizing our marketing approaches to increase emphasis on attracting learners who are more likely to persist in our programs;

- Promoting affordability and encouraging learners to persist by offering learner success grants to new learners who meet admissions requirements, enroll, apply within certain timeframes, and stay continuously enrolled; 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.

As a result of these initiatives, early cohort persistence improved by approximately four percent over the prior year. Early cohort persistence measures the four-quarter weighted moving average new cohort persistence rate during learners' first four quarters of enrollment. Our learner success strategy primarily focuses on the first four quarters, since learners tend to persist at a very high rate after that time period.

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

• Introducing prospective learners to Capella through channels such as mass media and strategic relationships with employers and professional organizations;

• Connecting with prospective learners by generating and nurturing inquiries through direct media such as natural search, our website, and display media; and

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Engaging with prospective learners by developing meaningful relationships such as through social media or direct engagement.

Our comprehensive marketing strategy is designed to produce long-term efficiencies and increase our ability to attract high-quality learners on a sustainable basis. While some of these initiatives may adversely impact our new enrollment, revenues, and operating margins for a period of time as we pursue improved long-term results, we believe that our return to reporting total enrollment growth in the third quarter of 2014 highlights the success of this strategy.

Establishing new growth platforms. We seek to drive long-term growth that is an extension of our core competencies into new and expanded markets. This may result in increased new business development costs focused on researching, identifying, and cultivating these new market opportunities.

We received approval to offer a new learning model called FlexPath in 2013. This new learning model is decoupled from the credit-hour requirements and allows learners to complete coursework at their own pace throughout each quarter and complete activities to demonstrate specific competencies by the end of the quarter. This offering is unique in that Capella University is the first institution with approval from the Higher Learning Commission and the Department of Education to offer programs at the Bachelor's and graduate level. These approvals allow learners enrolled in FlexPath to apply for federal financial aid. We believe this direct assessment model provides an opportunity to expand our served market and drive affordability through lower tuition costs, reduced time to completion, and increased flexibility. Currently, we offer six Department of Education approved programs including the Bachelor's and Master's of Business Administration, the Bachelor's and Master's in Information Technology, and the Bachelor's and Master's in Psychology.

We are making steady progress in developing FlexPath, but important work remains. Our goal is to ensure learners have the right experience and that we understand what our learners need to succeed. By year-end 2014, we expect FlexPath to approach three percent of total enrollment in our Master's and Bachelor programs.

In addition to benefiting FlexPath enrollments, our differentiated marketing strategy has also accelerated new enrollment growth in certain of our credit-hour based programs. Therefore, although FlexPath is a significant component of our long-term growth strategy, the primary driver for our total enrollment growth remains our credit-hour based programs.

Redesign of programs and specializations. In our continued efforts to drive affordability and speed to competency, we are focused on maximizing efficiencies in our existing programs while delivering the same learning outcomes. Our curriculum is based on competency mappings, which we are able to leverage as we redesign existing offerings. We believe these types of redesigns have the potential to increase persistence rates, learner success, and affordability.

Current market and regulatory environment. The market conditions remain challenging and competition is strong; however, we continue to focus on attracting the right learners and learner success. We believe our initiatives to improve learner success through innovation will position us to continue to be a leader in the online postsecondary education market. Additionally, we are working to even more closely align with employers. Developments in the federal regulatory environment impact us as well, including the upcoming release of the final gainful employment rules and the reauthorization of the Higher Education Act of 1965, as amended, and the current Department of Education rulemaking processes. Many states have also become more active in regulating online education, especially regarding approval to operate requirements, and enforcement of consumer protection laws by state attorneys general, with a focus on proprietary institutions. While we have a strong track record of regulatory compliance, such actions, even if not directed at Capella University, may result in unforeseen consequences and may make our operating environment more challenging.

Lease amendment. On April 3, 2014, we accepted notice to activate an amendment to our current lease for our premises at 225 South Sixth Street in Minneapolis, MN. Pursuant to the amendment, in June 2014, we returned 54,940 square feet of our previously leased space of 426,165 square feet. Employees located in this area were relocated to other areas within our remaining space. We recorded a charge of approximately \$2.6 million during the nine months ended September 30, 2014 in connection with this amendment, which is included within the lease amendment charge line item of the consolidated statements of income. We anticipate expense savings of approximately \$7.0 million through October 31, 2018, with approximately \$0.4 million of those savings expected in the fourth quarter of 2014.

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We also consolidated other leased office space resulting in an additional charge of \$0.1 million during the nine months ended September 30, 2014. This amount is included within the lease amendment charge line item of the consolidated statements of income.

### Regulatory Environment

The following summarizes significant regulatory matters applicable to our business. For a more detailed discussion of the regulatory environment and related risks, refer to Part 2, Item 7, Key Trends, Developments and Challenges, and Regulatory Environment in our 2013 Annual Report on Form 10-K for the fiscal year ended December 31, 2013.

**Gainful Employment.** The Department of Education published a Notice of Proposed Rulemaking (NPRM) on March 25, 2014. The proposed rule applies to all Gainful Employment (GE) programs, which include non-degree programs at public and private non-profit institutions, and all programs offered by for-profit institutions. The proposed rule is similar to the draft language last discussed at the third negotiated rulemaking committee session in December 2013. The rule establishes two “accountability metrics” that GE programs must satisfy in order to remain eligible for Title IV federal student aid, specifically debt to earnings (DTE) ratios and programmatic cohort default rate (pCDR) thresholds. Unlike the accountability metrics in the Department of Education’s previous GE rule, the accountability metrics under the Department of Education’s current proposal operate independently from one another. Consequently, in order for a GE program to maintain its Title IV eligibility under the proposed rule, it must satisfy both the DTE and pCDR requirements. The proposed rule also requires institutions to provide certifications regarding a GE program’s satisfaction of programmatic accreditation and state licensure requirements. Additionally, the proposed rule includes requirements for the reporting of student and program data by institutions to the Department of Education, and expands the disclosure requirements that have been in effect since July 1, 2011. The rule further makes other conforming and technical revisions to the Title IV program participation agreement and related regulations.

The rule closed for public comment on May 25, 2014. The Department of Education has until November 1, 2014 to publish a final rule in order for the rule to be effective July 1, 2015. The substance of final regulations dealing with gainful employment cannot be predicted at this time.

**Current negotiated rulemaking.** On November 20, 2013, the Department of Education announced another round of negotiated rulemaking to focus on the following issues: cash management of funds provided under the Title IV Federal Student Aid programs, including the use of debit cards and the handling of Title IV credit balances; state authorization for programs offered through distance education or correspondence education; state authorization for foreign locations of institutions located in a State; clock to credit hour conversion; definition of “adverse credit” for borrowers in the Federal Direct PLUS Loan Program; and application of the repeat coursework provisions to graduate and undergraduate programs. Negotiations took place February 19-21, March 26-28, and April 23-25, 2014. An additional session took place May 19-20, 2014 to examine the remaining issues and take a consensus vote on the entire rule making package. The Committee did not reach consensus at this session, and the development of the draft rule shifted back to the Department of Education.

On August 8, 2014, the Department of Education published a NPRM on the definition of “adverse credit” for borrowers in the Federal Direct PLUS Loan Program. The NPRM reflects agreed upon language established by the negotiated rulemaking committee. Public comment period ended on September 8, 2014, and a final rule was published on October 23, 2014. No other NPRMs from this round of negotiated rulemaking have been issued.

**Program Participation Agreement.** The Department of Education approved Capella University’s Program Participation Agreement (PPA) in August 2014. Capella University is fully certified by the Department of Education to participate in Title IV programs through June 30, 2020.

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Minnesota Office of Higher Education student debt information request. The Minnesota Office of Higher Education (MOHE) is developing state level metrics related to average 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 educational loan debt (excluding PLUS loans) of degree recipients by award level for 2011-2012. 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.

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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, if an institution's three-year cohort default rate exceeds 30% for three consecutive years, 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 the institution's 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. Capella University's three-year cohort default rates for the 2011, 2010, and 2009 cohorts are 13.0%, 10.9%, and 9.7%, respectively. The increase is primarily due to the overall economic environment, and a slight increase in the percentage of Capella University learners enrolled in a bachelor's 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, 2013. During the nine months ended September 30, 2014, there have been no significant changes to our critical accounting policies.

Results of Operations

Three Months Ended September 30, 2014 Compared to Three Months Ended September 30, 2013

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, 2014:

	Three Months Ended September 30,							
	(Unaudited)		\$ Change	% Change	% of Revenue			
\$ in thousands	2014	2013	2014 vs. 2013		2014	2013	2014 vs. 2013	
Revenues	\$103,097	\$100,703	\$2,394	2.4	% 100.0	% 100.0	% 0.0	%
Costs and expenses:								
Instructional costs and services	47,143	45,984	1,159	2.5	45.8	45.7	0.1	
Marketing and promotional	25,509	26,489	(980)	(3.7)	24.7	26.4	(1.7)	)
Admissions advisory	7,019	6,796	223	3.3	6.8	6.7	0.1	
General and administrative	10,250	10,924	(674)	(6.2)	9.9	10.8	(0.9)	)
Total costs and expenses	89,921	90,193	(272)	(0.3)	87.2	89.6	(2.4)	)
Operating income	13,176	10,510	2,666	25.4	12.8	10.4	2.4	
Other expense, net	(46)	(238)	192	(80.7)	—	(0.2)	0.2	)
Income before income taxes	13,130	10,272	2,858	27.8	12.8	10.2	2.6	
Income tax expense	5,373	4,262	1,111	26.1	5.2	4.2	1.0	
Effective tax rate	40.9	% 41.5	%					
Net income	\$7,757	\$6,010	\$1,747	29.1	% 7.6	% 6.0	% 1.6	%

Revenues. The increase in revenues compared to the same quarter in the prior year was primarily related to Capella University new enrollment growth, tuition increases, and an increase in average courses per learner. Capella University weighted average tuition increase in the current quarter was less than three percent and was implemented in July 2014. These increases were

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partially offset by a larger proportion of bachelor's and master's learners who generate less revenue per learner than our doctoral learners, an increase in grants to support our initiatives to improve learner success, other discounts, and a decrease in non-Capella University revenues.

**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 increased investment in our initiative to focus on coaching new learners during the first year of their academic experience, continued investment in course and program development, and increased headcount. This overall increase was partially offset by a decrease in amortization expense as a result of certain intangible assets associated with RDI becoming fully amortized in 2014, the prospective reallocation of share-based compensation expense related to awards granted to certain Company executives and members of its Board of Directors as general and administrative in 2014, and expense savings associated with the lease amendment which was effective in the second quarter of 2014.

**Marketing and promotional expenses.** Marketing and promotional expenses, and marketing and promotional expenses as a percent of revenue, decreased compared to the same quarter in the prior year primarily driven by cost efficiencies gained through optimization of our Capella University marketing efforts. This overall decrease was partially offset by additional employee expenses driven by increased headcount.

**Admissions advisory expenses.** Admissions advisory expenses, and admissions advisory expenses as a percent of revenue, increased compared to the same quarter in the prior year primarily due to increased enrollment services headcount to support higher Capella University inquiry volume.

**General and administrative expenses.** General and administrative expenses, and general and administrative expenses as a percent of revenue, decreased compared to the same quarter in the prior year primarily as a result of investments in our non-Capella University new market platforms and severance expense in the prior year. These decreases were partially offset by increased RDI expenses, and the reallocation of share-based compensation expense from instructional costs and services and marketing and promotional in 2014.

**Other expense, net.** Other expense, net was \$46 thousand for the three months ended September 30, 2014, and \$0.2 million for the three months ended September 30, 2013. The decrease compared to the same quarter in the prior year is primarily attributable to foreign currency exchange rates, and the impact of the change in fair value of the RDI contingent consideration liability in the prior year. The RDI contingent consideration liability was paid during the quarter ended June 30, 2014 as a result of the awarding of Taught Degree Awarding Powers (TDAP).

**Income tax expense.** The decrease in our effective tax rate compared to the same quarter in the prior year was primarily driven by a decrease in foreign operating losses in the current period. We do not receive a benefit on these losses due to the establishment of a full valuation allowance.

Nine Months Ended September 30, 2014 Compared to Nine Months Ended September 30, 2013

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, 2014:

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	Nine Months Ended September 30, (Unaudited)		\$ Change	% Change	% of Revenue		2014 vs. 2013	
	2014	2013			2014 vs. 2013	2014	2013	%
\$ in thousands								
Revenues	\$313,525	\$309,638	\$3,887	1.3	% 100.0	% 100.0	% 0.0	%
Costs and expenses:								
Instructional costs and services	139,973	137,851	2,122	1.5	44.6	44.5	0.1	
Marketing and promotional	74,383	76,091	(1,708)	(2.2)	23.7	24.6	(0.9)	)
Admissions advisory	21,092	20,294	798	3.9	6.7	6.6	0.1	
General and administrative	31,604	32,252	(648)	(2.0)	10.1	10.4	(0.3)	)
Lease amendment charges	2,690	—	2,690	100.0	0.9	—	0.9	
Total costs and expenses	269,742	266,488	3,254	1.2	86.0	86.1	(0.1)	)
Operating income	43,783	43,150	633	1.5	14.0	13.9	0.1	
Other expense, net	(559)	(463)	(96)	20.7	(0.2)	(0.1)	(0.1)	)
Income before income taxes	43,224	42,687	537	1.3	13.8	13.8	—	
Income tax expense	17,606	17,500	106	0.6	5.6	5.7	(0.1)	)
Effective tax rate	40.7	% 41.0	%					
Net income	\$25,618	\$25,187	\$431	1.7	% 8.2	% 8.1	% 0.1	%

Revenues. The increase in revenues compared to the same period in the prior year was primarily related to Capella University tuition increases and new enrollment growth, as well as RDI enrollment growth. Capella University tuition increase in the current period was less than three percent, which represents a weighted average of price increases implemented in July 2014 and 2013. This overall increase was partially offset by the impact of a larger proportion of bachelor's and certificate learners who generate less revenue per learner than our master's and doctoral learners, an increase in grants to support our initiatives to improve learner success, and other discounts.

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 period in the prior year primarily due to increased investment in our initiative to focus on coaching new learners during the first year of their academic experience, and continued investment in course and program development. This overall increase was partially offset by a decrease in amortization expense as a result of certain intangible assets associated with RDI becoming fully amortized in 2014, lower depreciation expense as a result of certain assets becoming fully depreciated in 2014, and the prospective reallocation of share-based compensation expense related to awards granted to certain Company executives and members of its Board of Directors as general and administrative in 2014.

Marketing and promotional expenses. Marketing and promotional expenses, and marketing and promotional expenses as a percent of revenue, decreased compared to the same period in the prior year primarily driven by cost efficiencies gained through optimization of our Capella University and RDI marketing efforts, lower depreciation expense as a result of certain assets becoming fully depreciated in 2014, as well as the prospective reallocation of share-based compensation expense to general and administrative in 2014. This overall decrease was partially offset by additional employee expenses driven by increased headcount.

Admissions advisory expenses. Admissions advisory expenses, and admissions advisory expenses as a percent of revenue, increased compared to the same period in the prior year primarily due to increased enrollment services headcount to support higher Capella University inquiry volume.

General and administrative expenses. General and administrative expenses, and general and administrative expenses as a percent of revenue, decreased compared to the same period in the prior year primarily as a result of the prior year's investment in our non-Capella University new market platforms, including delivery of a significant employer project; and reduced headcount in the current year. This decrease was partially offset by the reallocation of approximately \$0.8 million of share-based compensation expense from instructional costs and services and marketing and promotional in 2014, increased participation in monitoring and shaping government regulations, as well as an increase in human

resources contract staff.

Lease amendment charges. On April 3, 2014, we accepted notice to activate an amendment to our current lease for our premises at 225 South Sixth Street in Minneapolis, Minnesota. Pursuant to the amendment, in June 2014, we returned 54,940 square feet of our previously leased space of 426,165 square feet. We recorded a charge of \$2.6 million during the nine months

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ended September 30, 2014 in connection with this amendment. We also consolidated other leased office space resulting in an additional charge of \$0.1 million during the nine months ended September 30, 2014.

Other expense, net. Other expense, net was \$0.6 million for the nine months ended September 30, 2014, and \$0.5 million for the nine months ended September 30, 2013. The increase in expense compared to the same period in the prior year was primarily due to the change in fair value of the RDI contingent consideration liability which was paid during the quarter ended June 30, 2014 as a result of the awarding of TDAP; and also the result of foreign currency exchange rates and management fees related to our limited partnership investment.

Income tax expense. The decrease in our effective tax rate compared to the same period in the prior year was primarily driven by a decrease in foreign operating losses in the current period. We do not receive a benefit on these losses due to the establishment of a full valuation allowance.

## Liquidity and Capital Resources

### Liquidity

We financed our operating activities and capital expenditures during the nine months ended September 30, 2014 and 2013 primarily through cash provided by operating activities. Our cash and cash equivalents were \$90.5 million and \$124.1 million at September 30, 2014 and December 31, 2013, respectively. Our cash and cash equivalents decreased primarily due to net purchases of marketable securities, increased cash used in financing activities for repurchases of common stock, the payment of dividends, payment of the contingent consideration liability to RDI as a result of achievement of TDAP, and general business activities. This overall decrease in cash was partially offset by cash provided by operating 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, 2014, 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 were required to make an additional payment of £4.0 million to the former shareholders of RDI when RDI was granted Taught Degree Awarding Power (TDAP). On April 14, 2014, RDI received notice from the British government of being awarded TDAP. Pursuant to the terms of the acquisition agreement, upon achievement of TDAP on May 12, 2014, we made an additional payment of £4.0 million (approximately \$6.9 million) to the former shareholders of RDI.

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 \$47.5 million and \$53.2 million for the nine months ended September 30, 2014 and 2013, respectively. The decrease was primarily due to the effects of changes in operating assets and liabilities, including the accumulated change in fair value of the RDI contingent consideration liability paid to the former shareholders of RDI upon achievement of TDAP, as well as a decrease in depreciation and amortization expense. These decreases were partially offset by the increase in net income.

Investing Activities

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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 used in investing activities was \$52.3 million and \$29.6 million for the nine months ended September 30, 2014 and 2013, respectively.

Cash used in investing activities for the nine months ended September 30, 2014 consisted primarily of purchases of marketable securities and investments in property and equipment, which were partially offset by maturities of marketable securities. Net purchases and maturities of marketable securities represented a cash outflow of \$35.1 million and \$14.8 million during the nine months ended September 30, 2014 and 2013.

We believe the credit quality and liquidity of our investment portfolio as of September 30, 2014 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 \$15.8 million and \$14.8 million for the nine months ended September 30, 2014 and 2013, respectively, which primarily consisted of investments in learner success and enrollment management initiatives, academic quality, foundational priorities, enhancements to our visitor center and content management system, and investments in FlexPath programs.

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 \$28.8 million and \$2.0 million for the nine months ended September 30, 2014 and 2013, respectively. The increase in net cash used in financing activities is primarily the result of payments of cash dividends of \$13.0 million in the current period, and higher repurchases of our common stock compared to the prior period. In the first nine months of 2014, we repurchased \$14.3 million of common stock under our share repurchase program compared to \$4.8 million in the first nine months of 2013. Due to timing, cash payments made for shares repurchased in the first nine months of 2014 were \$14.0 million.

Additionally, as a result of the achievement of TDAP, we made a cash payment of £4.0 million (approximately \$6.9 million) to the former shareholders of RDI on May 12, 2014. Net cash used in financing activities of approximately \$6.0 million reflects the initial fair value of the RDI contingent consideration liability recorded at acquisition, while the remaining amount of \$0.9 million included within cash flows from operating activities represents the accumulated change in fair value of the RDI contingent consideration liability.

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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 were rated A- or higher as of September 30, 2014, and BBB+ or higher as of December 31, 2013, 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, 2014, 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 expense, net in the consolidated statements of income.

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

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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, 2014, 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, 2013.

## 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, 2014, the Company repurchased \$4.3 million of common stock under its share repurchase program.<sup>(1)</sup> Its remaining authorization for common stock repurchases was \$35.1 million at September 30, 2014. The following presents the Company's share repurchases during the quarter ended September 30, 2014:

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
7/1/2014 to 7/31/2014	28,748	\$ 57.13	28,748	\$37,757,349
8/1/2014 to 8/31/2014	14,728	66.17	14,728	36,782,761
9/1/2014 to 9/30/2014	27,342	63.15	27,342	35,056,077
Total	70,818	61.33	70,818	35,056,077

(1) The Company announced its current share repurchase program in July 2008. As of September 30, 2014, the Company's Board of Directors has authorized repurchases up to an aggregate amount of \$285.7 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 <sup>(1)</sup>	Filed electronically.
EX-101.SCH	XBRL Taxonomy Extension Schema Document <sup>(1)</sup>	Filed electronically.
EX-101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document <sup>(1)</sup>	Filed electronically.
EX-101.DEF	XBRL Taxonomy Extension Definition Linkbase Document <sup>(1)</sup>	Filed electronically.
EX-101.LAB	XBRL Taxonomy Extension Label Linkbase Document <sup>(1)</sup>	Filed electronically.

EX-101.PRE      XBRL Taxonomy Extension Presentation      Filed electronically.  
Linkbase Document<sup>(1)</sup>

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 28, 2014

J. Kevin Gilligan

Chief Executive Officer

(Principal Executive Officer)

/s/ Steven L. Polacek

October 28, 2014

Steven L. Polacek

Senior Vice President and Chief Financial Officer

(Principal Financial and Accounting Officer)