

CAPELLA EDUCATION CO

Form 10-Q

August 01, 2018

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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2018

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

CAPELLA EDUCATION COMPANY

(Exact name of registrant as specified in its charter)

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

Capella Tower	
225 South Sixth Street, 9 th Floor	55402
Minneapolis, Minnesota	(Zip Code)
(Address of principal executive offices)	
(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 ☒ 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, a smaller reporting company, or an emerging growth company. See definitions of "large accelerated filer," "accelerated filer," "smaller reporting company" and "emerging growth company," in Rule 12b-2 of the Exchange Act.

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

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) ☐ of the Exchange Act.

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 July 26, 2018 was 11,730,041.

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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 June 30, 2018 (Unaudited)	As of December 31, 2017
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 117,885	\$ 106,566
Marketable securities, current	37,589	45,226
Accounts receivable, net of allowance of \$7,865 at June 30, 2018 and \$7,979 at December 31, 2017	24,229	22,733
Prepaid expenses and other current assets	10,027	9,523
Total current assets	189,730	184,048
Marketable securities, non-current	34,386	29,570
Property and equipment, net	34,781	35,961
Goodwill	13,477	13,477
Intangibles, net	3,162	3,402
Deferred income taxes	871	2,839
Other assets	10,358	9,724
Total assets	\$ 286,765	\$ 279,021
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 1,254	\$ 2,281
Accrued liabilities	27,815	26,619
Dividends payable	328	5,228
Deferred revenue	15,635	13,849
Total current liabilities	45,032	47,977
Deferred rent	11,890	12,365
Other liabilities	2,413	3,288
Total liabilities	59,335	63,630
Shareholders' equity:		
Common stock, \$0.01 par value: Authorized shares — 100,000, Issued and Outstanding shares — 11,730 at June 30, 2018 and 11,635 at December 31, 2017	117	116
Additional paid-in capital	124,431	127,804
Accumulated other comprehensive loss	(211)	(110)

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Retained earnings	103,093	87,581
Total shareholders' equity	227,430	215,391
Total liabilities and shareholders' equity	\$ 286,765	\$ 279,021

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 June 30, 2018 2017		Six Months Ended June 30, 2018 2017	
	(Unaudited)			
Revenues	\$111,563	\$109,584	\$223,530	\$221,372
Costs and expenses:				
Instructional costs and services	49,350	48,369	97,782	96,781
Marketing and promotional	27,739	27,308	55,755	54,833
Admissions advisory	7,205	7,440	14,397	15,103
General and administrative	11,317	11,096	21,196	21,683
Merger-related costs	873	—	1,395	—
Total costs and expenses	96,484	94,213	190,525	188,400
Operating income	15,079	15,371	33,005	32,972
Other income, net	695	56	1,191	163
Income from continuing operations before income taxes	15,774	15,427	34,196	33,135
Income tax expense	3,984	4,672	8,559	11,209
Income from continuing operations	11,790	10,755	25,637	21,926
Income from discontinued operations, net of tax	—	—	—	95
Net income	\$11,790	\$10,755	\$25,637	\$22,021
Basic net income per common share:				
Continuing operations	\$1.01	\$0.92	\$2.20	\$1.89
Discontinued operations	—	—	—	0.01
Basic net income per common share	\$1.01	\$0.92	\$2.20	\$1.90
Diluted net income per common share:				
Continuing operations	\$0.99	\$0.90	\$2.14	\$1.83
Discontinued operations	—	—	—	0.01
Diluted net income per common share	\$0.99	\$0.90	\$2.14	\$1.84
Weighted average number of common shares outstanding:				
Basic	11,703	11,644	11,674	11,602
Diluted	11,963	11,992	11,957	11,965
Cash dividend declared per common share	\$0.43	\$0.41	\$0.86	\$0.82

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 June 30, 2018 2017 (Unaudited)		Six Months Ended June 30, 2018 2017	
Net income	\$11,790	\$10,755	\$25,637	\$22,021
Other comprehensive income:				
Foreign currency translation gain (loss)	(1	) —	(2	) 3
Unrealized gains (losses) on available for sale securities, net of tax	—	5	(99	) 87
Comprehensive income	\$11,789	\$10,760	\$25,536	\$22,111

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)

	Six Months Ended June 30,	
	2018	2017
	(Unaudited)	
Operating activities		
Net income	\$25,637	\$22,021
Income from discontinued operations, net of tax	—	95
Income from continuing operations	25,637	21,926
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for bad debts	5,870	5,225
Depreciation and amortization	9,638	10,112
Amortization of investment discount/premium, net	537	855
Impairment of property and equipment	916	440
Loss on disposal of property and equipment	89	243
Share-based compensation	4,571	3,479
Deferred income taxes	2,000	2,443
Changes in operating assets and liabilities		
Accounts receivable	(7,366)	(5,194)
Prepaid expenses and other current assets	352	294
Accounts payable and accrued liabilities	(3,193)	(8,565)
Income taxes payable	(1,076)	3,219
Deferred rent	(475)	(735)
Deferred revenue	1,866	2,413
Net cash provided by operating activities - continuing operations	39,366	36,155
Net cash provided by operating activities - discontinued operations	—	95
Net cash provided by operating activities	39,366	36,250
Investing activities		
Capital expenditures	(9,075)	(12,116)
Investment in partnership interests	(784)	(354)
Purchases of marketable securities	(33,702)	(29,456)
Maturities of marketable securities	35,855	35,995
Net cash used in investing activities - continuing operations	(7,706)	(5,931)
Net cash provided by investing activities - discontinued operations	—	3,243
Net cash used in investing activities	(7,706)	(2,688)
Financing activities		
Net proceeds (payments) for exercise of stock options	(333)	1,273
Taxes paid for restricted stock units	(4,949)	(905)
Payment of dividends	(15,057)	(9,479)
Net cash used in financing activities - continuing operations	(20,339)	(9,111)
Effect of foreign exchange rates on cash	(2)	2
Net increase in cash and cash equivalents	11,319	24,453
Cash and cash equivalents at beginning of period	106,566	93,570
Cash and cash equivalents at end of period	\$117,885	\$118,023
Supplemental disclosures of cash flow information		
Income taxes paid	\$7,712	\$5,562
Non-cash investing and financing activities:		
Purchase of equipment included in accounts payable and accrued liabilities	\$528	\$741

Declaration of cash dividend to be paid	\$—	\$4,847
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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, Inc. (the University); Sophia Learning, LLC (Sophia); Capella Learning Solutions, LLC (CLS); Hackbright Academy, Inc. (Hackbright); and DevMountain, LLC (DevMountain). 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.

Sophia is an innovative learning company which leverages technology to support self-paced learning, including courses eligible for transfer into credit at over 2,000 colleges and universities. CLS provides online non-degree, high-demand, job-ready skills training solutions and services to individuals and corporate partners through Capella University's learning platform. Hackbright is a leading software engineering school for women with a mission to close the gender gap in the high-demand software engineering space. DevMountain is a leading software development school with a mission to be the most impactful coding school in the country by offering affordable, high-quality, leading-edge software coding education.

On February 8, 2016, the Company's Board of Directors approved a plan to divest its wholly owned subsidiary, Arden University Limited (Arden University). On August 18, 2016, the Company completed the sale of 100% of the share capital of Arden University. Beginning in the first quarter of 2016 and through the date of sale of the business, the assets and liabilities of Arden University were considered to be held for sale, and the Company presented Arden University as discontinued operations within the financial statements and footnotes. During the three and six months ended June 30, 2017, the Company recorded a gain of \$0.1 million related to the divestiture of Arden University.

2. Strayer Merger

On October 29, 2017, the Company entered into an Agreement and Plan of Merger (the "Merger Agreement") with Strayer Education, Inc. ("Strayer") and Sarg Sub Inc. ("Merger Sub"). Strayer is the holding company of Strayer University, which is an institute of higher learning which offers undergraduate and graduate degree programs in business administration, accounting, information technology, education and public administration.

Pursuant to the terms of the Merger Agreement, which was unanimously approved by the boards of directors of both companies, Merger Sub will merge with and into the Company with the Company surviving as a wholly-owned subsidiary of Strayer (the "Merger"). Following the completion of the Merger, Strategic Education, Inc. will be the corporate entity under which both Capella University and Strayer University will continue to operate as independent and separately accredited institutions.

On November 22, 2017, the U.S. Federal Trade Commission granted early termination of the applicable waiting period under the Hart-Scott-Rodino Antitrust Improvements Act of 1976. In addition, on January 19, 2018, the Merger agreement was approved by the stockholders of the Company and Strayer. By letter dated February 26, 2018, the Department of Education issued the results of its preacquisition review of the proposed change in ownership of the Company. That letter confirms that, subject to submission of additional documents following the closing, Capella University will have uninterrupted participation in the Title IV Programs while the Department of Education completes its review of the relevant documentation. On July 6, 2018, the Company received notice that the Board of Trustees of the Higher Learning Commission, Capella's regional accreditor, voted to approve the application for a

change in ownership of Capella University filed in connection with the Merger Agreement. The Merger is expected to close on August 1, 2018. At the effective time of the Merger, each share of the Company's stock will be exchanged for 0.875 shares of Strayer common stock.

During the three and six months ended June 30, 2018, the Company incurred \$0.9 million and \$1.4 million, respectively, in expenses primarily related to consulting, legal fees, and integration costs in connection with the proposed Merger Agreement. These costs are included in Merger-related costs within the Consolidated Statements of Income for the three and six months ended June 30, 2018.

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3. Summary of Significant Accounting Policies

Consolidation

The consolidated financial statements include the accounts of the Company, the University, Sophia, CLS, Hackbright, DevMountain, and Arden University after elimination of intercompany accounts and transactions. Arden University was divested during the third quarter of 2016, and prior to the date of sale was presented as discontinued operations within the financial statements and corresponding footnotes.

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. 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, 2017 (2017 Annual Report on Form 10-K).

Reclassifications

During the year-ended December 31, 2017 the Company began presenting the cash outflows associated with taxes paid to taxing authorities on an employee's behalf for restricted stock unit award releases within financing activities in the Consolidated Statements of Cash Flows rather than within operating activities based on the guidance set forth within Accounting Standards Update (ASU) 2016-09. The Company has applied this provision of the new standard retrospectively, and as such has restated net cash provided by operating activities and net cash used in financing activities for the impact of taxes paid to taxing authorities on an employee's behalf for restricted stock unit award releases within the Consolidated Statements of Cash Flows for the prior periods presented.

Impairment of Property and Equipment

The Company reviews its property and equipment for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to undiscounted future net cash flows expected to be generated by the asset. If such assets are considered not recoverable, a potential impairment loss is recognized to the extent the carrying amount of the assets exceeds the fair value of the assets. The Company recorded impairment charges related to the impairment of assets classified as property and equipment of \$0.9 million during the three and six months ended June 30, 2018. During the three and six months ended June 30, 2017, the Company recorded impairment charges of \$0.1 million and \$0.4 million, respectively. For the three and six month periods ended June 30, 2018, the impairment charges of \$0.9 million primarily consist of the write-off of previously capitalized internal software development costs related to software projects within the Company's Job-Ready Skills segment for which the expected future net cash flows may not exceed the carrying value of the related assets. These charges are recorded in the Consolidated Statements of Income and classified as instructional costs and services.

Share-Based Compensation

During the six months ended June 30, 2018, the Company granted restricted stock unit awards to a limited number of employees which are required to be settled in cash upon vesting. The restricted stock unit awards to be settled in cash are classified as Accrued liabilities in the Consolidated Balance Sheet as of June 30, 2018. The value of these awards is marked to market each period based on the fair value of the Company's common stock at the end of the reporting period, and changes in fair value are recorded in earnings. Share-based compensation expense included in the

Consolidated Statements of Income for restricted stock unit awards to be settled in cash was \$2.1 million and \$2.8 million during the three and six months ended June 30, 2018, respectively. There were no cash payments for restricted stock awards to be settled in cash during the three and six months ended June 30, 2018. As of June 30, 2018, there was \$0.9 million of total unrecognized pre-tax compensation cost related to restricted stock awards to be settled in cash that is expected to be recognized over a weighted-average period of 1.5 years.

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Use of Estimates

The preparation of the consolidated financial statements in accordance with GAAP requires management to make certain estimates, assumptions, and judgments that affect the reported amounts in the consolidated financial statements and accompanying footnotes. Actual results could differ from those estimates.

Refer to the Company's "Summary of Significant Accounting Policies" footnote included within the 2017 Annual Report on Form 10-K for a complete summary of the Company's significant accounting policies.

4. Recent Accounting Pronouncements

In August 2016, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2016-15, Classification of Certain Cash Receipts and Cash Payments, which is included in FASB Accounting Standards Codification (ASC) Topic 230, Statement of Cash Flows. The new guidance clarifies how companies present and classify certain cash receipts and cash payments in the statement of cash flows, including contingent consideration payments made after a business acquisition. Specifically, cash payments to settle a contingent consideration liability which are not made soon after the acquisition date should be classified as cash used in financing activities up to the initial amount of contingent consideration recognized with the remaining amount classified as cash flows from operating activities. The Company adopted this guidance as of January 1, 2018, and it did not have an impact on its business practices, financial condition, results of operations, or disclosures.

In June 2016, the FASB issued ASU No. 2016-13, Financial Instruments - Credit Losses, which is included in ASC Topic 326, Measurement of Credit Losses on Financial Instruments. The new guidance revises the accounting requirements related to the measurement of credit losses and will require organizations to measure all expected credit losses for financial assets based on historical experience, current conditions and reasonable and supportable forecasts about collectability. Assets must be presented in the financial statements at the net amount expected to be collected. The guidance will be effective for the Company's annual and interim reporting periods beginning January 1, 2020, with early adoption permitted. The Company does not expect adoption of this guidance to have a material impact on its business practices, financial condition, results of operations, or disclosures.

In February 2016, the FASB issued ASU No. 2016-02, Leases, to require organizations that lease assets to recognize right-to-use assets and lease liabilities for all leases with terms longer than 12 months on the balance sheet in addition to disclosing certain key information about leasing arrangements. The new standard requires a modified retrospective transition approach, meaning the guidance would be applied at the beginning of the earliest comparative period presented within the financial statements in the year of adoption. The guidance will be effective for the Company's annual reporting period beginning January 1, 2019, with early adoption permitted. The Company expects to adopt this standard at the beginning of fiscal year 2019, and all leases with terms longer than 12 months will be recorded as right-of-use assets and lease liabilities on our balance sheet upon adoption. The Company does not expect adoption of this guidance to have a material impact on its business practices, financial condition, results of operations, disclosures, liquidity, or debt-covenant compliance.

In January 2016, the FASB issued ASU No. 2016-01, Financial Instruments - Overall: Recognition and Measurement of Financial Assets and Financial Liabilities. The new guidance revises the accounting requirements related to the classification and measurement of investments in equity securities and the presentation of certain fair value changes for financial liabilities measured at fair value. The update also changes certain disclosure requirements associated with the fair value of financial instruments. These changes will require an entity to measure, at fair value, investments in equity securities and other ownership interests in an entity - including investments in partnerships, unincorporated joint ventures and limited liability companies that do not result in consolidation and are not accounted for under the

equity method - and recognize the changes in fair value within net income. Entities that hold equity investments without readily determinable fair values will be able to elect to record those investments at cost less impairment with subsequent adjustments for any observable price changes recognized in earnings. The Company has provided the required disclosures related to investments in partnerships within Footnote 14, Other Investments. As these investments are not traded and the partnerships do not publish a fair value per share, the investments are deemed to be without readily determinable fair values, and the Company has elected the option to record the investments at cost less impairment and recognize subsequent adjustments for any observable price changes within earnings. The Company adopted this guidance as of January 1, 2018, and it did not have a material impact on its business practices, financial condition, results of operations, liquidity, or debt-covenant compliance.

In May 2014, the FASB issued ASU No. 2014-09, 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 historical guidance, and is primarily based on recognizing revenue at an amount that reflects

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consideration to which the entity expects to be entitled to in exchange for transferring goods or services to a customer. The standard allows the Company to transition to the new model using either a full or modified retrospective approach. Under the original ASU, the guidance was effective for the Company's interim and annual reporting periods beginning January 1, 2017, and early adoption was not permitted. In August 2015, the FASB issued ASU No. 2015-14, Revenue from Contracts with Customers, Deferral of the Effective Date, which formally defers the effective date of the new revenue standard for public entities by one year. As a result, the updated revenue guidance is effective for the Company's interim and annual reporting periods beginning January 1, 2018, and early adoption is permitted as of the original effective date contained within ASU 2014-09. The Company adopted this guidance during the first quarter of 2018 utilizing the modified retrospective method of adoption, and the adoption of this guidance did not have a material impact on the Company's business practices, financial condition, or results of operations during the three and six months ended June 30, 2018. The primary impact of adopting the new standard has been modifications to the timing of revenue recognition for certain revenue streams, and we recorded a net cumulative increase to retained earnings and a corresponding decrease to deferred revenue in the amount of \$0.1 million as of January 1, 2018 as a result of the adoption of this guidance. The Company has provided expanded disclosures pertaining to revenue recognition within Footnote 5 - Revenues.

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 business practices, financial condition, results of operations, or disclosures.

5. Revenues

Impact of Adoption of ASC 606 - Revenue from Contracts with Customers

On January 1, 2018, the Company adopted ASC Topic 606, Revenue from Contracts with Customers, following the modified retrospective adoption method. The new guidance was applied to all contracts that were not completed as of the adoption date. Revenues and operating results for the reporting period beginning January 1, 2018 have been presented under the accounting guidance included within ASC Topic 606, while prior period amounts have not been restated to conform to the new guidance as permitted by the modified retrospective method of adoption.

As a result of the adoption of ASC Topic 606, the Company recorded a net cumulative increase to retained earnings of \$0.1 million and a corresponding decrease to deferred revenue within the Consolidated Balance Sheet as of January 1, 2018. The impact of adoption was related to tuition revenues across both the Post-Secondary and Job-Ready Skills segments. For the three and six months ended June 30, 2018, the net impact to revenues as a result of the adoption of ASC 606 was a reduction of revenues of \$10 thousand and \$152 thousand, respectively, with a corresponding increase to deferred revenue. The reduction to revenues as a result of adoption for the six months ended June 30, 2018 is related to tuition revenues across both the Post-Secondary and Job-Ready Skills segments.

The Company has elected, as practical expedients, to not disclose the value of unsatisfied performance obligations for contracts with customers that have an expected duration of one year or less and also will not adjust the transaction price for the impact of a significant financing component for contracts where the period of time between when the Company provides educational services and when the learner is expected to pay for those service is less than one year, as permitted by ASC Topic 606.

Revenue Recognition

The following table presents the Company's revenues from contracts with customers disaggregated by material revenue category, in thousands:

Three Months	Six Months Ended
Ended June 30,	June 30,

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	2018	2017	2018	2017
Post-Secondary revenue				
Tuition, net of discounts, grants, and scholarships	\$ 103,962	\$ 103,156	\$ 208,479	\$ 208,698
Other ¹	4,576	3,818	9,244	7,757
Total Post-Secondary revenue	108,538	106,974	217,723	216,455
Job-Ready Skills revenue ²	3,025	2,610	5,807	4,917
Consolidated revenue	\$ 111,563	\$ 109,584	\$ 223,530	\$ 221,372

(1) Post-Secondary other revenue is primarily comprised of course materials and bookstore sales.

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(2) Job-Ready Skills revenue is primarily comprised of tuition revenue and placement fee revenue.

The Company's revenues primarily consist of tuition revenue arising from educational services provided in the form of online courses offered to Capella University FlexPath and GuidedPath learners as well as in-person residency events for certain doctoral learners enrolled in specific programs. Tuition revenue is deferred and recognized as revenue ratably over the period of instruction, which varies depending on the course format and chosen program of study. Tuition revenue is recognized over time as learners obtain control of the educational services provided by the Company subsequent to enrollment and on a ratable basis over the term of the course beginning on the course start date through the last day of classes or the end of the twelve week FlexPath subscription period. For GuidedPath (traditional credit-hour) learners who withdraw or drop a course, the Company follows the University refund policy, which generally is: 100% refund through five days, 75% refund from six to twelve days, and zero percent refund for the remainder of the period. The Company does not recognize revenue for GuidedPath learners who enroll but never engage in the courseroom. FlexPath learners receive a 100% refund through calendar day twelve of the subscription period for their first billing session only and a zero percent refund after that date and for all subsequent billing sessions. Refunds are recorded as a reduction of revenue in the period that the learner withdraws from a course. A small number of FlexPath learners who participate in certain employer-sponsored tuition reimbursement programs with Capella University are eligible for a full refund of tuition if they do not successfully complete at least one FlexPath course they are enrolled in during a given subscription period. For these particular learners, revenue recognition is constrained to the extent that the Company expects to provide a full refund to eligible learners based on historical refund experience. Residency program revenue is recognized over the length of the residency, which generally ranges from three to 42 days. When the University is required to return funds distributed under Title IV Programs of the Higher Education Act (Title IV or Title IV Programs) to the Department of Education, the learner is not released from his or her payment obligation.

GuidedPath learners are eligible to receive Capella University-awarded grants and scholarships depending on their program eligibility and academic standing. These grants and scholarships vary in amount depending upon the program of study and are generally available to new GuidedPath learners who have successfully completed their first Capella course or a series of Capella courses over a specified period of time. Additionally, FlexPath learners who are employed by, or members of, Capella University's partner organizations may be eligible to receive Capella University-awarded grants or scholarships. The existence of grants and scholarships gives rise to variable consideration, and the recognition of revenue arising from eligible learners is constrained to the extent that management estimates such learners will be eligible to receive the benefits associated with a grant or scholarship.

For learners who drop all courses or withdraw from Capella University with an unpaid tuition balance, the Company records revenue at the time of cash collection, unless the learner re-enrolls in a course during the same time period in which the course was started. Based on the Company's historical experience, it is not probable that the Company will collect substantially all of the consideration related to such unpaid tuition balances. Accordingly, during the period in which a learner drops all courses or withdraws from Capella University prior to finalizing coursework, no additional revenue is recognized until payment is received from the learner.

Course materials enable learners to electronically access all required materials for courses they are enrolled in during the quarter, including access to e-books, articles, course packs, software, test kits, labs, and any other materials that would be required to successfully complete the course. Revenue derived from course materials is recognized in a manner consistent with tuition revenue as the Company provides the learner with continuous and uninterrupted access to these materials over the period of instruction beginning on the course start date and through the last day of the course.

For bookstore sales, the Company is considered to be the agent in the transaction because it does not control distribution to learners or bear the risk of loss of inventory in transit; as such, the Company only recognizes the

mark-up on cost portion of the bookstore sale as revenue. Net bookstore revenue is recognized at the time of delivery of the textbook to the learner.

Deferred revenue in any period represents the excess of tuition and fees received as compared to tuition and fees recognized as revenue in the consolidated statements of income and is reflected as a current liability or within Other liabilities, as appropriate, within the Company's Consolidated Balance Sheets. The increase in deferred revenue as of June 30, 2018 compared to December 31, 2017 is primarily related to increased new and total enrollment growth in the current period and the timing of course start dates within the academic calendar for GuidedPath programs at Capella University. Additionally, \$0.8 million and \$12.6 million of revenue that was recognized during the three and six months ended June 30, 2018, respectively, had been included in the deferred revenue balance within the Consolidated Balance Sheet at the beginning of the period.

The Company's general payment terms require that learners remit payment for tuition and other related charges prior to the beginning of the course start date in order to be eligible to participate in the course, with limited exceptions. Learners are permitted to carry only a small outstanding unpaid tuition balance that, if exceeded, would prevent the learner from enrolling in

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future courses. For Capella University learners who are eligible to receive Federal Title IV loans to cover the cost of tuition, Title IV funds are remitted by the federal government to Capella University and are subsequently applied to a learner's account. Amounts received are included within the deferred revenue balance until the associated revenue is recognized in accordance with the Company's revenue recognition policy.

6. 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 June 30, 2018		Six Months Ended June 30, 2017	
Numerator:				
Income from continuing operations	\$ 11,790	\$ 10,755	\$ 25,637	\$ 21,926
Income from discontinued operations, net of tax	—	—	—	95
Net income	\$ 11,790	\$ 10,755	\$ 25,637	\$ 22,021
Denominator:				
Denominator for basic net income per common share— weighted average shares outstanding	11,703	11,644	11,674	11,602
Effect of dilutive stock options, restricted stock, and market stock units	260	348	283	363
Denominator for diluted net income per common share— weighted average shares outstanding	11,963	11,992	11,957	11,965
Basic net income per common share:				
Continuing operations	\$ 1.01	\$ 0.92	\$ 2.20	\$ 1.89
Discontinued operations	—	—	—	0.01
Basic net income per common share	\$ 1.01	\$ 0.92	\$ 2.20	\$ 1.90
Diluted net income per common share:				
Continuing operations	\$ 0.99	\$ 0.90	\$ 2.14	\$ 1.83
Discontinued operations	—	—	—	0.01
Diluted net income per common share	\$ 0.99	\$ 0.90	\$ 2.14	\$ 1.84

Options to purchase common shares were outstanding, but not included in the computation of diluted net income per common share on both a continuing and discontinued basis, because their effect would be anti-dilutive. The following table summarizes these securities, in thousands:

	Three Months Ended June 30, 2018	Six Months Ended June 30, 2017
Anti-dilutive securities excluded from diluted earnings per share calculation, for both continuing and discontinued operations	—121	16 106

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7. Marketable Securities

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

As of June 30, 2018				
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Estimated Fair Value
Tax-exempt municipal securities	\$26,248	\$ 4	\$ (43)	\$ 26,209
Corporate debt securities	36,478	11	(273)	36,216
Variable rate demand notes	9,550	—	—	9,550
Total	\$72,276	\$ 15	\$ (316)	\$ 71,975

As of December 31, 2017				
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Estimated Fair Value
Tax-exempt municipal securities	\$35,070	\$ —	\$ (87)	\$ 34,983
Corporate debt securities	16,102	8	(92)	16,018
Variable rate demand notes	23,795	—	—	23,795
Total	\$74,967	\$ 8	\$ (179)	\$ 74,796

The unrealized gains and losses on the Company's investments in municipal and corporate debt securities as of June 30, 2018 and December 31, 2017 were caused by changes in market values primarily due to interest rate changes. Substantially all of the Company's securities which were in an unrealized loss position as of June 30, 2018 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 at maturity. No other-than-temporary impairment charges were recorded during the three and six months ended June 30, 2018 and 2017.

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

	As of June 30, 2018	As of December 31, 2017
Due within one year	\$37,589	\$ 45,226
Due after one year through five years	34,386	29,570
Total	\$71,975	\$ 74,796

Amounts due within one year in the table above included \$9.6 million of variable rate demand notes, with contractual maturities ranging from 4 years to 31 years as of June 30, 2018. The variable rate demand notes are floating rate municipal bonds with embedded put options that allow the Company to sell the security at par plus accrued interest on a settlement basis ranging from one day to seven days. We have classified these securities based on their effective maturity date, which ranges from one day to seven days from the balance sheet date.

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Maturities of marketable securities	\$24,055	\$25,455	\$35,855	\$35,995
Total	\$24,055	\$25,455	\$35,855	\$35,995

The Company did not record any gross realized gains or gross realized losses in net income during the three and six months ended June 30, 2018 and 2017. Additionally, there were no proceeds from sales of marketable securities prior to maturity during the three and six months ended June 30, 2018 and 2017.

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8. Fair Value Measurements

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

Description	Fair Value	Fair Value Measurements as of June 30, 2018 Using		
		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	\$8,059	\$ 8,059	\$ —	\$ —
Money market	108,527	108,527	—	—
Commercial paper	1,299	—	1,299	—
Marketable securities:				
Tax-exempt municipal securities	26,209	—	26,209	—
Corporate debt securities	36,216	—	36,216	—
Variable rate demand notes	9,550	—	9,550	—
Total assets at fair value on a recurring basis	\$189,860	\$ 116,586	\$ 73,274	\$ —

Description	Fair Value Measurements as of December 31, 2017 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	\$17,951	\$17,951	\$ —	\$ —
Money market	88,615	88,615	—	—
Marketable securities:				
Tax-exempt municipal securities	34,983	—	34,983	—
Corporate debt securities	16,018	—	16,018	—
Variable rate demand notes	23,795	—	23,795	—
Total assets at fair value on a recurring basis	\$181,362	\$106,566	\$ 74,796	\$ —

The Company measures cash and money markets 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 observable inputs from active markets. 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 six months ended June 30, 2018 and 2017.

Level 3 Measurements

DevMountain Contingent Consideration

In connection with the acquisition of DevMountain, the Company agreed to pay the former owners of DevMountain up to an additional \$5.0 million in contingent consideration pending the achievement of certain revenue and operating performance metrics. The fair value of the contingent consideration is determined using a discounted cash flow model encompassing significant unobservable inputs. The key assumptions and terms underlying the valuation included probability-weighted cash flows for the applicable performance periods, the discount rate, and a three-year measurement period, with potential cash payments taking place at the end of each annual period through 2018 based upon the achievement of established performance targets. No payments were made related to the 2016 or 2017 performance periods, and no amounts are accrued related to the 2018 performance period. Reasonable changes in the unobservable inputs do not result in a material change in the fair value.

The fair value of the contingent consideration was zero as of June 30, 2018 and December 31, 2017.

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9. Accrued Liabilities

Accrued liabilities consist of the following, in thousands:

	As of June 30, 2018	As of December 31, 2017
Accrued compensation and benefits	\$10,836	\$ 9,151
Accrued instructional	3,588	3,662
Accrued vacation	1,493	1,122
Accrued invoices	9,820	10,683
Other ⁽¹⁾	2,078	2,001
Total	\$27,815	\$ 26,619

(1) "Other" consists primarily of the current portion of deferred rent, customer deposits, and other miscellaneous accruals.

10. Commitments and Contingencies

Operating Leases

The Company leases its office facilities, data centers, and certain office equipment under various noncancelable operating leases. On August 5, 2016, 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, 2028. Renewal terms under the amended lease agreement included a reduction in the area of leased space occupied by the Company of approximately 64,000 square feet and provided for lease incentives of approximately \$13.6 million. The lease incentives, which were paid in cash to the Company by the lessor upon closing, are included within deferred rent and accrued liabilities within the Consolidated Balance Sheets and will be recognized ratably as a reduction of rent expense over the term of the lease. The agreement allows the Company to extend the lease for up to two additional five-year terms.

The following presents the Company's future minimum lease commitments as of June 30, 2018, in thousands:

2018	\$3,489
2019	5,782
2020	5,355
2021	4,742
2022	4,550
2023 and thereafter	28,305
Total	\$52,223

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 expense from the date the Company takes possession of the property through the end of the lease term. The Company includes the short-term and long-term components of the unamortized portion of the lease incentives within accrued liabilities and deferred rent, respectively, on the Consolidated Balance Sheets.

Revolving Credit Facility

On December 18, 2015, the Company entered into a secured revolving credit facility (the Facility) with Bank of America, N.A., and certain other lenders. The Facility provides the Company with a committed \$100.0 million of

borrowing capacity with an increase option of an additional \$50.0 million. The Company's obligations under the Facility are guaranteed by all existing material domestic subsidiaries and secured by substantially all assets of the Company and such subsidiaries. The Facility expires by its terms on December 18, 2020.

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.

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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 income, net, for the three and six months ended June 30, 2018 and 2017. Outstanding letters of credit are also charged a fee, based on the Company's consolidated leverage ratio. The Company capitalized approximately \$0.8 million of debt issuance costs related to the December 18, 2015 credit facility, and these costs are being amortized on a straight-line basis over a period of five years. Charges related to the Facility are included in other income, 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 June 30, 2018 and December 31, 2017, there were no borrowings under the Facility, and the Company was in compliance with all debt covenants. The Company will terminate the Credit Agreement upon completion of the Merger with Strayer Education, Inc.

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. In addition, the Merger with Strayer Education, Inc. also may subject the Company to shareholder or other related litigation. While the outcome of these matters is uncertain, the Company does not believe there are any significant matters as of June 30, 2018 that are probable and estimable, for which the outcome could have a material adverse impact on its consolidated financial position or results of operations.

11. Share Repurchase Program and DividendsShare 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 June 30, 2018, 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
December 2015	50,000
Total amount authorized	335,662
Total value of shares repurchased	308,702
Residual authorization	\$26,960

During the three and six months ended June 30, 2018 and 2017, there were no share repurchases.

As of June 30, 2018, the Company had purchased an aggregate of 6.7 million shares under the program's outstanding authorizations at an average price per share of \$46.28 totaling \$308.7 million, excluding commissions.

Dividends

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During the six months ended June 30, 2018, the Company declared the following cash dividends, in thousands except per share amounts:

Declaration Date	Record Date	Payment Date	Dividend Total	
			per Share	Dividend Amount
February 21, 2018	March 8, 2018	April 13, 2018	\$ 0.43	\$ 5,090
April 30, 2018	May 24, 2018	June 29, 2018	\$ 0.43	\$ 5,121

Dividends declared are attributable to shares of common stock outstanding as of the record date and restricted stock units (RSUs). Dividends declared on RSUs are forfeitable prior to vesting. All future dividends are subject to declaration by the

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Company's Board of Directors and may be adjusted due to future business needs or other factors deemed relevant by the Board of Directors.

12. Share-Based Compensation

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Instructional costs and services	\$185	\$240	\$370	\$428
Marketing and promotional	237	257	473	468
Admissions advisory	7	12	14	25
General and administrative	2,391	1,696	3,714	2,558
Share-based compensation expense included in operating income	2,820	2,205	4,571	3,479
Tax benefit from share-based compensation expense	676	864	1,096	1,350
Share-based compensation expense, net of tax	\$2,144	\$1,341	\$3,475	\$2,129

13. Income Taxes

On December 22, 2017, the Tax Cuts and Jobs Act of 2017 ("Tax Reform") was signed into law making significant changes to the Internal Revenue Code. Changes included, but are not limited to, a corporate tax rate decrease from 35% to 21% and modification of the employee compensation limit effective for tax years beginning after December 31, 2017. The Company has calculated its best estimate of the impact of the Act in its income tax provision in accordance with its understanding of Tax Reform and guidance available as of the date of this filing.

The Company recorded income tax expense of \$4.0 million and \$8.6 million for the three and six months ended June 30, 2018, reflecting an effective tax rate of 25.3% and 25.0%, respectively. During the three and six months ended June 30, 2017, the Company recorded income tax expense of \$4.7 million and \$11.2 million, reflecting an effective tax rate of 30.3% and 33.8%, respectively. The decrease in income tax expense is primarily attributable to the reduction in the federal corporate income tax rate under Tax Reform. The difference between the effective tax rates and the statutory tax rates for the three and six months ended June 30, 2018 primarily consists of state income taxes, employee compensation in excess of deductible limitations, nondeductible merger-related costs, and share-based compensation tax deductions. The difference between the effective tax rates and the statutory tax rates for the three and six months ended June 30, 2017 primarily consists of state income taxes, employee compensation in excess of deductible limitations, and share-based compensation tax deductions.

On December 22, 2017, Staff Accounting Bulletin No. 118 ("SAB 118") was issued to address the application of US GAAP in situations when a registrant does not have the necessary information available, prepared, or analyzed (including computations) in reasonable detail to complete the accounting for certain income tax effects of Tax Reform. As of June 30, 2018, no significant measurement period adjustments have been made. Given the significant complexity of Tax Reform, additional work is necessary to perform a more detailed analysis of these items, and any subsequent adjustment to these amounts will be recorded in the period that the analysis is complete.

14. Other Investments

At June 30, 2018, the Company held a \$4.0 million investment in a limited partnership that invests in innovative companies in the health care field, with a commitment to invest up to an additional \$0.4 million through December 2022. At December 31, 2017, the Company's investment in the limited partnership was \$3.9 million. During the six months ended June 30, 2018 and 2017, the Company made investments totaling \$0.1 million and \$0.4 million, respectively, in the partnership. The Company's investment comprises less than 3% of the total partnership interest.

At June 30, 2018, the Company held a \$4.0 million investment in a limited partnership that invests in education and education-related technology companies, with a commitment to invest up to an additional \$0.7 million through December 2025. At December 31, 2017, the Company's investment in the limited partnership was \$3.5 million. During the six months ended June 30, 2018, the Company made investments totaling \$0.5 million in the partnership, and during the six months ended June 30, 2017, the Company made no investments in the partnership. The Company's investment comprises less than 5% of the total partnership interest.

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At June 30, 2018, the Company held a \$0.6 million investment in a limited partnership that invests in education and education-related technology companies, with a commitment to invest up to an additional \$2.1 million through September 2027. At December 31, 2017, the Company's investment in the limited partnership was \$0.4 million. During the six months ended June 30, 2018, the Company made investments totaling \$0.2 million in the partnership, and during the six months ended June 30, 2017, the Company made no investments in the partnership. The Company's investment comprises less than 5% of the total partnership interest.

The Company adopted ASU No. 2016-01, Financial Instruments - Overall: Recognition and Measurement of Financial Assets and Financial Liabilities, as of January 1, 2018. According to the guidance, entities that hold equity investments without readily determinable fair values will be able to elect to record those investments at cost less impairment with subsequent adjustments for any observable price changes recognized in earnings. As the other investments are not traded and the partnerships do not publish a fair value per share, these investments are deemed to be without readily determinable fair values, and the Company has elected the option to record other investments at cost less impairment and recognize subsequent adjustments for any observable price changes within earnings.

During the six months ended June 30, 2018 and 2017, no events or changes in circumstances which could have a significant adverse impact on the fair value of the partnership investments were identified, and there were no observable price changes recognized in earnings with respect to these investments. Additionally, during the six months ended June 30, 2018 and 2017, no impairment charges were recorded related to the partnership investments. As no impairment charges were recorded and because no observable price changes occurred during the period, the Company's other investments are reflected at cost within the other assets balance in the Consolidated Balance Sheets as of June 30, 2018 and December 31, 2017. When measured on a nonrecurring basis, if changes in circumstances are identified, the Company's partnership investments are considered to be Level 3 in the fair value hierarchy due to the use of unobservable inputs to measure fair value.

15. Accumulated Other Comprehensive Loss

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

	Foreign Currency Translation Loss	Unrealized Loss on Marketable Securities	Accumulated Other Comprehensive Loss ⁽¹⁾
Beginning balance, December 31, 2017	\$ (3)	\$ (107)	\$ (110)
Other comprehensive income (loss)	(2)	(99)	(101)
Ending balance, June 30, 2018	\$ (5)	\$ (206)	\$ (211)

(1) Accumulated other comprehensive loss is presented net of tax of \$95 thousand and \$64 thousand as of June 30, 2018 and December 31, 2017, respectively.

There were no reclassifications out of accumulated other comprehensive loss to net income for the three and six months ended June 30, 2018 and 2017.

16. Segment Reporting

Capella Education Company is an educational services company that provides access to high-quality education through online postsecondary degree programs and job-ready skills offerings in high-demand markets. Capella's portfolio of companies is dedicated to closing the skills gap by placing adults on the most direct path between learning and employment.

Our only operating segment that meets the quantitative thresholds to qualify as a reportable segment is the Post-Secondary segment, which consists of the Capella University and Sophia businesses. None of our other operating segments meet the quantitative thresholds to qualify as reportable segments; therefore, these other operating segments are combined and presented below as Job-Ready Skills. The Job-Ready Skills reportable segment is comprised of the CLS, Hackbright, and DevMountain businesses.

Revenue and operating expenses are generally directly attributed to our segments. Inter-segment revenues are not presented separately, as these amounts are immaterial. Our Chief Operating Decision Maker does not evaluate operating segments using asset information.

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A summary of financial information by reportable segment (in thousands) for the three and six months ended June 30, 2018 and 2017 is presented in the following table. Beginning in the first quarter of 2016 through the date of the sale of the business, Arden University was considered to be held for sale, and because Arden's results of operations are presented as discontinued operations within our Consolidated Statements of Income, the summary of financial information by reportable segment below excludes the results of operations of Arden University for all periods presented.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Revenues				
Post-Secondary	\$108,538	\$106,974	\$217,723	\$216,455
Job-Ready Skills	3,025	2,610	5,807	4,917
Consolidated Revenues	\$111,563	\$109,584	\$223,530	\$221,372
Operating income (loss)				
Post-Secondary	\$18,029	\$17,754	\$37,473	\$38,005
Job-Ready Skills	(2,077)	(2,383)	(3,073)	(5,033)
Merger-related costs	(873)	—	(1,395)	—
Consolidated operating income	15,079	15,371	33,005	32,972
Other income, net	695	56	1,191	163
Income from continuing operations before income taxes	\$15,774	\$15,427	\$34,196	\$33,135

17. Regulatory Supervision and Oversight

Political and budgetary concerns can 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 June 30, 2018, Title IV 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 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 of 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," "expects," "anticipates," "future," "intends," "plans," "believes," "convinced," "estimates," "seeks," "target," "goal," "objective," and similar expressions, as well as statements in future tense, are intended to identify forward-looking statements, but are not the exclusive means of identifying such statements.

Forward-looking statements involve risks and uncertainties which may cause actual results to differ materially from those in such statements. Factors that could cause actual results to differ from those suggested by 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, 2017, as updated in our subsequent reports filed with the SEC, including any updates or circumstances described in 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 other factors common to businesses and investments, or to the general economy. Forward-looking statements are qualified by some or all of these risks. Therefore, you should consider these risk factors with caution and form your own independent conclusions about the likely effect of these risks on our future performance. 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 such statement is made to reflect the occurrence of unanticipated events or circumstances. Readers should carefully review all the disclosures and risk factors described in this and other documents we file from time to time with the SEC.

Executive Overview

We are an education services company that seeks to provide the most direct path between learning and employment through our online postsecondary education offerings and through programs to develop job-ready skills for high-demand markets. As of June 30, 2018, our wholly owned subsidiaries included the following:

Post-Secondary Segment

Capella University (the University) offers a variety of doctoral, master's and bachelor's programs, primarily for working adults, in the following markets: public service leadership, nursing and health sciences, social and behavioral sciences, business and technology, education, and undergraduate studies. We focus on master's and doctoral degrees, with 71% of our learners enrolled in a master's or doctoral degree program. Our academic offerings are built with competency-based curricula and are delivered in an online format that is convenient and flexible. We design our offerings to help working adult learners develop specific competencies they can apply in their workplace. We actively support and engage with our learners throughout their programs to enhance their prospects for successful program completion. We believe the relevance of our programs, combined with a focus on working adult professionals and

offering the most direct path to learners' professional and academic goals, sets Capella University apart in the education space. At June 30, 2018, we offered over 2,100 online courses and 53 academic programs with 143 specializations to nearly 38,000 learners.

• Sophia Learning, LLC (Sophia) is an innovative learning company which leverages technology to support self-paced learning, including courses eligible for transfer into credit at over 2,000 colleges and universities.

Job-Ready Skills Segment

• Capella Learning Solutions, LLC (CLS) provides online, non-degree training solutions and services to individuals and corporate partners focused on the delivery of job-ready skills in high-demand employment areas, including

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through RightSkill. RightSkill provides job seekers with unique learning experiences that prepare them for in-demand careers and partners with employers looking for verified, job-ready candidates.

Hackbright Academy, Inc. (Hackbright) is a leading software engineering school for women with a mission to close the gender gap in the high-demand software engineering space. Hackbright's primary offering is an intensive 12-week accelerated software development program for women, together with placement services and coaching. This program is a live, in-person educational experience held in Hackbright's classrooms in the San Francisco Bay Area. Hackbright partners with employers to facilitate alumnae transition from program completion into the workplace.

DevMountain, LLC (DevMountain) is a leading software development school with a mission to be the most impactful coding school in the country by offering affordable, high-quality, leading-edge software coding education.

DevMountain primarily offers Web Development, iOS Development, and UX Design programs in a 12-week immersive experience. Learners engage in DevMountain courses in-person, at DevMountain's classrooms in Provo and Salt Lake City, Utah, Dallas, Texas, and Phoenix, Arizona. In 2017, DevMountain introduced its first online program in Web Development.

We believe we have the right operating strategies in place to provide the most direct path between learning and employment for our learners. We focus on innovation 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 learners' 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.

Strayer Merger

On October 29, 2017, the Company entered into an Agreement and Plan of Merger (the "Merger Agreement") with Strayer Education, Inc. ("Strayer") to combine in an all-stock merger of equals transaction, creating a national leader in education innovation. Following the completion of the Merger, Strategic Education, Inc. will be the corporate entity under which both Capella University and Strayer University will continue to operate as independent and separately accredited institutions.

Pursuant to the terms of the Merger Agreement, which was unanimously approved by the boards of directors of both companies, Merger Sub will merge with and into the Company with the Company surviving as a wholly-owned subsidiary of Strayer (the "Merger"), which will be renamed Strategic Education, Inc., upon closure of the merger transaction.

On November 22, 2017, the U.S. Federal Trade Commission granted early termination of the applicable waiting period under the Hart-Scott-Rodino Antitrust Improvements Act of 1976. On January 19, 2018, the Merger Agreement was approved by the stockholders of the Company and Strayer. By letter dated February 26, 2018, the Department of Education issued the results of its preacquisition review of the proposed change in ownership of the Company. That letter confirms that, subject to submission of additional documents following the closing, Capella University will have uninterrupted participation in the Title IV Programs while the Department of Education completes its review of the relevant documentation. On July 6, 2018, the Company received notice that the Board of Trustees of the Higher Learning Commission, Capella's regional accreditor, voted to approve the application for a change in ownership of Capella University filed in connection with the Merger Agreement. The merger is expected to close on August 1, 2018. At the effective time of the Merger, each share of the Company's stock will be exchanged for 0.875 shares of Strayer common stock.

During the three and six months ended June 30, 2018, the Company incurred \$0.9 million and \$1.4 million, respectively, in expenses pertaining to the Merger Agreement, primarily attributable to consulting, legal fees, and integration costs.

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:

Innovation. We operate in a very competitive market environment, and we have demonstrated that we can effectively compete and differentiate in our market. Our long-term success will depend on our ability to continue innovating around our competency-based learning capacities to develop new academic and business models. We

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will need to balance investments that may put pressure on near-term operating income performance with our goal to achieve operating performance improvements and deliver short and long-term shareholder value.

Capella University total enrollment. Total enrollment at Capella University is a key driver for the Company's revenue growth as well as operating performance. To achieve total enrollment growth, Capella University must attract new learners and maintain and/or improve learner persistence. Total enrollment growth requires both sustained new enrollment growth over several quarters as well as stable or improved learner persistence as a result of the large population of total enrollment (all learners) relative to new enrollment (first-time learners.) While new enrollment is an early indicator of future growth, early cohort persistence is an indicator of the sustainability of growth. These metrics should be viewed over multiple quarters because quarterly volatility is common. We have consistently improved early cohort persistence over a period of more than six years, and these persistence improvements carry into later periods. In the second quarter of 2018, end-of-period total enrollment grew by 0.5 percent year-over-year compared to total enrollment declines of 1.7 percent in the same period of 2017. Total enrollment growth was primarily driven by growth in bachelors and doctoral total enrollments.

Capella University new enrollment. In the second quarter of 2018, Capella University new enrollment, calculated from the last day a new learner can drop a course without financial penalty, increased by 14.7 percent year-over-year compared to new enrollment declines of 9.6 percent in the same period in 2017. New enrollment growth occurred at all degree levels.

Persistence/learner success. Compared to the same period in the prior year, Capella University early cohort persistence remained relatively unchanged. Early cohort persistence measures the four-quarter weighted moving average new cohort persistence rate during a learner's first four quarters of enrollment. We have experienced improvements in early cohort persistence of approximately 22 percent over a period of more than six years, in large part as a result of our successful execution of strategic, organization-wide learner success initiatives aimed at driving total enrollment growth and improved learner outcomes. This includes investments in infrastructure, analytics capabilities, learner support and a marketing strategy focused on attracting the right learners.

We are focused on sustaining and improving learner success rates, particularly in the first four quarters of enrollment while maintaining a high standard of academic quality and rigor. The first four quarters of enrollment are particularly critical because learners tend to persist at a very high rate after that period. We continue to increasingly focus on the entire learner lifecycle. Certain initiatives to improve learner success can affect our growth and profitability in the near-term. However, we believe these efforts are in the best interest of our learners and over the long-term will enhance our brand and reputation, which, in turn, positions us for more sustainable long-term growth. Learner success initiatives include the following:

- Investing in our actionable analytics capabilities to further leverage data, refine our models, and accurately predict the likelihood of prospective, new, and current learners persisting to critical thresholds of success and to help provide individualized paths to improve a learner's opportunity to succeed;

- Providing timely and clear information to our learners, faculty, advisors and staff to help learners persist and successfully complete their programs;

- Redesigning programs to improve academic quality, remove unintended barriers that can disrupt learner progression, and deliver operational process efficiencies;

- 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;

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

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Promoting affordability and encouraging learners to persist by offering learner success scholarships 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 which have potential to increase affordability and better serve the life-long learning needs of working adult professionals and therefore increase learner success.

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Doctoral enrollment. During the second quarter of 2018, doctoral total enrollment for Capella University increased by 0.9 percent compared to the same period in the prior year. Consistent doctoral total enrollment growth will depend on sustained new enrollment growth over several quarters as well as maintaining or improving learner success.

Marketing strategy. During the course of the past few years, we have made significant strides in shifting from a demand driven strategy towards a comprehensive marketing strategy which is focused on building relationships with prospective learners early in their decision cycle. In addition, we are developing opportunities in the employer channel to build brand awareness and differentiation. With our vision of providing the most direct path between learning and employment and our dedication to serving the Job-Ready Skills market, we are changing the conversation with employers and are working to further strengthen and articulate our differentiation.

Our learner-focused marketing strategy, which is designed to attract prospective Capella University learners who are committed to and able to succeed in their academic endeavors, includes:

- Introducing prospective learners to Capella with a differentiated message in 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, display media, and through paid search platforms and aggregators; and
- Engaging with prospective learners by developing meaningful and increasingly personalized relationships such as through social media, via mobile devices, or by way of direct engagement.

Our employer-focused marketing strategy, which is designed to strengthen Capella's differentiation with employers, includes:

- Offering a platform of capabilities which range from Capella University's post-secondary degrees to shorter programs in the Job-Ready Skills software engineering and coding areas to targeted skill-building programs;
- Developing new programs such as Capella University's Workforce Edge, where an employee can earn a degree with little to no out-of-pocket costs when she or he leverages employer tuition reimbursement. This program enables employers to attract, support, and retain more productive employees utilizing a competency-based learning solution; and
- Leveraging Capella University's state of the art, competency-based direct assessment programs to offer employers innovative solutions that fit their learning objectives and their budgets and which provide reporting tools to track participants' competency development.

Our comprehensive marketing strategy is designed to produce long-term efficiencies and increase our ability to attract high-quality learners on a sustainable basis. In our efforts to optimize our marketing spend, we continue to experiment with different methods and levels to provide prospective learners with the information they are looking for at the right time and in the right way. We are also continuing to adapt to the evolving behavior of prospective learners as they move closer to a decision about going back to school, including differences in behavior and responsiveness between learners connecting with us through mobile versus desktop devices. We will continue to optimize our strategy and develop our marketing analytics capabilities to continue to deliver long-term sustainable growth. Some of our initiatives may adversely impact our new enrollment, revenues, and operating margins for a period as we pursue improved long-term results.

Establishing new growth platforms. We seek to drive long-term growth that is an extension of our core competencies into new and expanded markets. One of our key growth platforms is FlexPath. FlexPath is a learning model that decouples from the credit-hour requirements and allows learners to complete coursework at their own pace through the demonstration of specific competencies. Capella University was the first institution with approval from the Higher Learning Commission and the Department of Education to offer and provide Title IV funding for direct assessment

programs at both the Bachelor's and Master's degree levels. These approvals allow learners enrolled in FlexPath to apply for federal financial aid. Only a few other universities received approvals by their accreditor and the Department of Education to offer similar programs. Approval processes for this innovative model are stringent, and the Department of Education has indicated that direct assessment program specializations will also require specific approval by the Higher Learning Commission and the Department of Education to offer

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Title IV. This adds another step in the approval process with both the Department of Education and the Higher Learning Commission.

FlexPath offerings have continued to grow, and as of June 30, 2018, Capella University offered the following FlexPath offerings:

- ✶ Bachelor of Science in Business;
- ✶ Bachelor of Science in Information Technology;
- ✶ Bachelor of Science in Psychology;
- ✶ Registered Nurse to Bachelor of Science in Nursing;
- ✶ Master of Business Administration;
- ✶ Master of Science in Psychology;
- ✶ Master of Education;
- ✶ Master of Health Administration; and
- ✶ Master of Science in Nursing.

All of the specializations within these FlexPath offerings have received approval from the Higher Learning Commission. Additionally, all of the specializations within our FlexPath offerings have received approval from the Department of Education to be eligible to receive federal financial aid under Title IV, except for the six applications currently pending.

The FlexPath 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. Our goals are to ensure learners have the right experience and that we understand what our learners need to do to succeed. As we continue to learn and gain experience, we will refine the academic model and evolve the business model for FlexPath. At June 30, 2018, approximately 23 percent of total bachelor's and master's learners were enrolled in FlexPath courses.

CLS offerings. In 2013, the Company introduced the first set of CLS offerings - online training solutions and services to corporate partners. CLS focuses its offerings on non-degree training solutions and services to individuals and corporate partners focused on the delivery of job-ready skills in high-demand employment areas.

Coding schools performance. Throughout 2017, Hackbright and DevMountain continued to develop their offerings. In May 2017, DevMountain received approval to begin operating in Phoenix, and in the fourth quarter 2017, DevMountain introduced its first online program offering. During the first six-months of 2018, Hackbright opened two new classrooms in the San Francisco Bay Area. Since the dates of acquisition, we have made investments in both businesses to position them for scalable growth and will continue to make additional investments for the foreseeable future. Although both acquisitions have had a positive impact on our revenue growth, Hackbright and DevMountain have not achieved the degree of revenue growth initially anticipated or met operating performance expectations, and these trends are expected to continue. As a result, during the year ended December 31, 2017, we recorded goodwill and intangible asset impairment charges of \$15.0 million based on the results of the goodwill and intangible assets impairment analysis. If the overall trend in revenue growth and operating performance of the coding schools continues and operating improvements as discussed above are not realized, some or all of the remaining goodwill and intangible assets associated with the Coding Schools reporting unit could become impaired in the future, resulting in the recognition of additional impairment charges.

Redesign of programs and specializations. We continue to evaluate our existing offerings for opportunities to drive affordability and speed to competency, enhance learner success, meet employer needs, maintain programmatic approvals and fulfill evolving regulatory standards. Utilizing our competency-based curriculum mapping, we are focused on maximizing efficiencies in our existing programs, resulting in improved learning and career outcomes.

Current market and regulatory environment. The environment remains very competitive. We believe our initiatives to improve learner success and innovation in our academic and business model, as well as our efforts to increase productivity and achieve greater economies of scale where possible, will position us to continue to be a leader in the online postsecondary education market. Additionally, we are working even more closely to align with employers. Developments in federal regulations may have an impact on us as well, including the Gainful

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Employment (GE) rules, Borrower Defense to Repayment rules, and the reauthorization of the Higher Education Act of 1965, as amended. 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. We continue to make investments and take actions to maintain our consistently high compliance with regulatory requirements.

Tax Cuts and Jobs Act of 2017. On December 22, 2017, the Tax Cuts and Jobs Act of 2017 ("Tax Reform") was signed into law making significant changes to the Internal Revenue Code. Changes included, but are not limited to, a corporate tax rate decrease from 35% to 21% and modification of the employee compensation limit effective for tax years beginning after December 31, 2017. The Company recorded income tax expense of \$4.0 million and \$8.6 million for the three and six months ended June 30, 2018, which reflects an effective tax rate of 25.3% and 25.0%, respectively. During the three and six months ended June 30, 2017, the Company recorded income tax expense of \$4.7 million and \$11.2 million, respectively, reflecting an effective tax rate of 30.3% and 33.8%, respectively. The decrease in income tax expense is primarily attributable to the reduction in the federal corporate income tax rate under Tax Reform.

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 2017 Annual Report on Form 10-K.

U.S. Legislation and Congressional Activity. It is unclear when Congress will reauthorize the Higher Education Act (HEA) which governs federal financial assistance for higher education. When reauthorization of HEA is considered, it will create opportunity to expand innovation in the delivery of higher education. As with any new legislation, there is also a risk of unintended consequences from new laws and regulatory requirements. Capella maintains strong relationships with policy makers and a reputation for quality. We will work to be a constructive voice in any dialogue on innovation in higher education.

We cannot predict what legislation, if any, may emanate from Congressional committee hearings or what impact such legislation might have on proprietary institutions and our business in particular. Congressional scrutiny of proprietary institutions increases the likelihood of legislation that will adversely impact our business. In addition, when Congress addresses federal budget deficits, financial aid programs are a potential target for reduction.

If Congress reduced the amount of available Title IV program funding, we would attempt to arrange for alternative sources of financial aid for our learners, but private sources would not be able to provide as much funding to our learners or on terms comparable to Title IV. In addition, private funding sources 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, if at all, the impact on our business of reduced Title IV program funding, and would not be a practical alternative in the case of a significant reduction in Title IV financial aid.

Gainful Employment (GE) and Department of Education. The final Gainful Employment rule went into effect on July 1, 2015. It applies to all GE programs, which include non-degree programs at public and private non-profit institutions, and all programs offered by proprietary institutions. The rule establishes a "debt-to-earnings" (DTE) ratio that GE programs must satisfy over the course of annual measurement periods to remain eligible for Title IV federal student aid. A program is determined to "pass" in a given year if the calculation shows that the graduates who received loans have annual loan payments less than 8% of total earnings OR less than 20% of discretionary earnings. A program is determined to "fail" in a given year if the calculation shows that graduates who received loans have annual

loan payments greater than 12% of total earnings AND greater than 30% of discretionary earnings. A program is determined to be in the “Zone” in a given year if the program does not “pass,” AND if the calculation shows that graduates who received loans have annual loan payments between 8% and 12% of total earnings OR between 20% and 30% of discretionary earnings.

In January 2017, we received final DTE ratios from the Department of Education for 2015 - the first measurement year. The DTE ratios we received showed that none of our programs was determined to fail. This is significant because the rules state that a program would be ineligible for Title IV funds in the next year if it failed in two out of three consecutive years, whereas for a program in the zone, a program would be ineligible for Title IV funds in the

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next year only if it were in the zone (or failed) in each of four consecutive years. The DTE ratio information we received reflected one of our programs (the Master's of Science in Marriage and Family Counseling/Therapy program) was in the zone. Since January 2017, we have not received any additional DTE ratios from the Department of Education for periods subsequent to the first measurement year. We have taken and continue to take steps to avoid or mitigate potential adverse consequences of the DTE ratio rules. Despite our efforts, it remains possible that one or more of our programs could be determined to be in the zone or fail in future calculations.

The final rule also requires institutions to provide certifications regarding a GE program's satisfaction of programmatic accreditation and state licensure requirements as part of the institutional program participation agreements with the Department of Education. The certification requirements went into effect on December 31, 2015 in connection with the Department of Education's program participation agreement recertification; however, new programs introduced between July 1 and December 31, 2015 were to be certified prior to such program's introduction to establish eligibility for Title IV federal financial aid. We worked with the Department of Education to clarify various issues related to the new certification requirements, and certified our programs as required by the final GE rule and requirements of the Department of Education.

The final rule also includes requirements for the reporting of learner and program data by institutions to the Department of Education. The rule makes other conforming and technical revisions to the Title IV program participation agreement and related regulations. The Department of Education has announced that enforcement of certain expanded disclosure and distribution requirements under the current final rule are postponed until July 1, 2019.

On June 16, 2017, the Department of Education announced its intention to establish a rulemaking committee to examine and revise the Gainful Employment regulation, which it called "overly burdensome and confusing for institutions of higher education." The Department of Education conducted public hearings on Gainful Employment and Borrower Defense to Repayment in July 2017, in addition to soliciting written comments on both topics. Capella University submitted comments in July 2017. The Borrower Defense to Repayment negotiated rulemaking committee and the Gainful Employment negotiated rulemaking committees wrapped up their meetings in early 2018. Neither committee reached consensus. On July 25, 2018, the Department of Education released its draft Borrower Defense to Repayment rules. The Department of Education will accept public comments through August 30, 2018. The proposed changes outline the circumstances in which a borrower could submit claims on loans made after July 1, 2019, in addition to changes to the financial responsibility requirements. We are currently reviewing the draft rule to assess the overall impact on Capella University. The Department of Education has indicated that it intends to release final rules addressing Gainful Employment and Borrower Defense to Repayment by November 1, 2018, to go into effect in July 2019.

Current negotiated rulemaking. On October 12, 2016 the Department of Education published final rules related to teacher preparation and the Teacher Education Assistance for College and Higher Education (TEACH) grant requirements for distance education programs. The regulations clarified that institutions that do not have initial teacher licensure programs have no obligation to report anything to any state under the new requirements. The final rules clarified that TEACH Grant funds are specifically available to students enrolled in graduate degree programs (which do not lead to initial teacher licensure) for teachers and others in high-need education fields. Capella University ended its participation in the TEACH Grant Program effective in October 2016. The published final rules were to be effective July 1, 2017; however, in early 2017, the United States Congress invoked the Congressional Review Act authority to overturn this regulation, which was signed into law by President Trump in March 2017.

In 2014, the Department of Education published a Notice of Proposed Rulemaking (NPRM) indicating its intent to convene a negotiated rulemaking committee on the topics of credit to clock hour conversion, state authorization, cash management, retaking coursework and the definition of adverse credit for PLUS loans. On October 30, 2015, the Department of Education published final rules on cash management, repeat coursework and clock to credit hour

conversion. With the exception of a few provisions within the cash management rule that provide an extra year for implementation, the rules generally became effective on July 1, 2016.

The Department of Education released final rules on December 16, 2016 regarding state authorization of distance education, correspondence and foreign programs. These proposed rules require distance education programs to be authorized in every state and/or participate in a state authorization reciprocity agreement. In 2015, Capella University became an institutional member of SARA (see below). Included in the final rules are a number of general and individualized disclosures for prospects and learners including how programs are authorized,

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complaint processes, adverse actions by state and accrediting agencies, and prerequisites for licensure or certification for certain programs. On July 3, 2018, the Department of Education announced a delay of distance education provisions of the 2016 final regulations until July 1, 2020. Separately, the Department of Education has also announced its intention to conduct negotiated rulemaking to reconsider selected provisions of the 2016 final state authorization regulations.

The Department of Education published final rules on November 1, 2016 which set forth expanded criteria, and substantial discretion for the Department of Education, with respect to borrower rights and relief in defense to repayment of Title IV loans. In particular, for recipients of loans disbursed on or after July 1, 2017, the rule permits student loan debt relief, upon borrower application, where there is:

- State or Federal court or administrative tribunal judgment against a school related to the loan or the educational services for which the loan was made;
- Breach of contract; or
- Substantial misrepresentation by the school.

The regulation grants the Department of Education broad discretion to determine whether a school has committed a breach of contract or substantial misrepresentation, to allow group claims, which may include individuals who have not applied to the Department of Education seeking relief, and to determine when to seek recoupment from the school upon loan discharge. In addition, the final rules expand the events triggering a determination that an institution is unable to meet its financial or administrative obligations to include certain automatic triggers, such as failure to satisfy the 90/10 regulation in the most recent fiscal year, a cohort default rate in excess of 30 percent in the two most recent years, and failure to comply with certain SEC requirements, as well as discretionary triggers such as certain federal, and private actions, unspecified dropout rates, unspecified fluctuations in Title IV funding, and actions by the school's accreditor. In the event of such a triggering event, an institution may become ineligible for Title IV funds or be required to post a letter of credit in the amount of at least 10% of the school's annual Title IV disbursements for each triggering event, and make disclosure to learners and prospective learners. In addition, the rule increases access to closed school discharges and prohibits the use of pre-dispute arbitration agreements. Finally, the rule makes other conforming and technical changes to repayment plans and loan consolidation. While the rule was slated to go into effect July 1, 2017, on June 16, 2017 the Department of Education announced an indefinite postponement of the borrower defense to repayment regulation. On the same day, the Department of Education announced its intent to establish rulemaking committees to develop proposed revisions to the existing gainful employment regulation as well as the borrower defense to repayment regulation. The Department of Education conducted public hearings on Gainful Employment and Borrower Defense to Repayment in July 2017, in addition to soliciting written comments on both topics. Capella University submitted comments in July 2017. The Borrower Defense to Repayment negotiated rulemaking committee and the Gainful Employment negotiated rulemaking committees wrapped up their meetings in early 2018. Neither committee reached consensus, which frees the Department to draft rules without including input from the committees. The Department of Education has indicated it intends to release final rules addressing both Borrower Defense to Repayment and Gainful Employment by November 1, 2018, to go into effect July 1, 2019.

The Department of Education has indicated its intention to conduct negotiated rulemaking in early 2019 to create and amend regulations relating to, among other topics, the definition of the credit hour, competency-based education, direct assessment programs, regular and substantive interaction between faculty and students in the delivery of distance education programs, state authorization of distance and correspondence programs, and the Secretary's recognition of accrediting agencies and accreditation procedures.

Minnesota Office of Higher Education (MOHE). Capella University is registered as a private institution with the MOHE pursuant to Minnesota Statute sections 136A.61-131A.71 as required for most post-secondary private institutions that grant degrees at the associate level or above in Minnesota, and as required by the Higher Education Act to participate in Title IV programs.

On October 13, 2016, Capella University received a request for information from MOHE related to its doctoral programs and complaints filed by doctoral students. According to the request, MOHE is completing program reviews of all online doctoral programs for institutions registered in Minnesota in an effort to better understand the context, background, and issues related to doctoral student complaints. The Company provided data and information in response to MOHE's request. On July 28, 2017, the Company received correspondence from

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MOHE confirming the Company's responses fulfilled the original request and asking for certain clarifying and supplemental information. The Company provided clarifying and supplemental information in response.

State Authorization Reciprocity Agreement (SARA). SARA is a nationwide state regulatory initiative intended to make distance education courses more accessible to learners across state lines and make it easier for states to regulate and institutions to participate in interstate distance education. On January 27, 2015, Minnesota joined SARA, and on March 6, 2015, Capella University was approved as an institutional participant in SARA. There are currently 49 SARA member states.

MOHE is the designated "portal agency" that oversees institutions headquartered in Minnesota that participate in SARA. As the portal agency, MOHE's responsibilities include coordinating SARA matters for Minnesota and acting as the principal point of contact for resolution of student complaints.

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.

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 three-year measuring period student loan cohort default rate equals or exceeds 30% for three consecutive cohort years, or 40% for any given year. Capella University's three-year cohort default rates for the 2014, 2013, and 2012 cohorts are 6.9%, 6.5%, and 8.9%, respectively. The average cohort default rates for proprietary institutions nationally were 15.5%, 15.0%, and 15.8% in cohort years 2014, 2013, and 2012, respectively. The average cohort default rates for all institutions nationally were 11.5%, 11.3%, and 11.8% in cohort years 2014, 2013 and 2012, respectively.

Higher Learning Commission. The Higher Learning Commission, Capella University's accrediting body, is continuously developing new standards and approval processes under which it evaluates programs and institutions. Consistent with that approach, on August 31, 2016, the Higher Learning Commission adopted policy changes which include giving the Commission more discretion to designate institutions to be in "financial distress" or under "government investigation." In November 2017, the HLC announced additional policy changes to become effective September 1, 2019, mandating certain recruitment, admissions and related institutional practices, and in November 2017, the HLC introduced guidelines for shared services relationships. While the Company believes its strong reputation and compliance record will continue to place it in favorable standing with the Higher Learning Commission, compliance with the new policies may increase risk, cost and operational complexity.

On July 6, 2018, the Higher Learning Commission notified the Company that the Higher Learning Commission Board of Trustees voted at its June 28-29, 2018 meeting to approve the change in ownership application filed by Capella University in connection with the Merger Agreement with Strayer. As required by Higher Learning Commission policy and federal regulation, Capella University will host a focused visit by Higher Learning Commission within six months of the date the Merger closes.

Critical Accounting Policies and Use of Estimates

Our critical accounting policies are disclosed in our 2017 Annual Report on Form 10-K. Other than as disclosed in Footnote 4 - Recent Accounting Pronouncements, there were no substantial changes to our critical accounting policies during the six months ended June 30, 2018.

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Analysis of Results of Operations - Consolidated

Three Months Ended June 30, 2018 Compared to Three Months Ended June 30, 2017

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 June 30, 2018 compared to the three months ended June 30, 2017:

\$ in thousands	Three Months Ended June 30, (Unaudited)		\$ Change		% Change	% of Revenue		2018 vs. 2017
	2018	2017	2018	vs. 2017		2018	2017	
Revenues	\$111,563	\$109,584	\$1,979	1.8	%	100.0%	100.0%	0.0 %
Costs and expenses:								
Instructional costs and services	49,350	48,369	981	2.0		44.2	44.1	0.1
Marketing and promotional	27,739	27,308	431	1.6		24.9	24.9	—
Admissions advisory	7,205	7,440	(235)	(3.2)	)	6.5	6.8	(0.3)
General and administrative	11,317	11,096	221	2.0		10.1	10.1	—
Merger-related costs	873	—	873	*		0.8	—	0.8
Total costs and expenses	96,484	94,213	2,271	2.4		86.5	86.0	0.5
Operating income	15,079	15,371	(292)	(1.9)	)	13.5	14.0	(0.5)
Other income, net	695	56	639	*		0.6	0.1	0.5
Income before income taxes	15,774	15,427	347	2.2		14.1	14.1	—
Income tax expense	3,984	4,672	(688)	(14.7)	)	3.6	4.3	(0.7)
Effective tax rate	25.3	% 30.3	%					
Net income	\$11,790	\$10,755	\$1,035	9.6	%	10.6 %	9.8 %	0.8 %

* Not meaningful.

Capella University Enrollment by Degree ^(a) :	June 30,		% Change
	2018	2017	
Doctoral	9,129	9,052	0.9 %
Master's	17,540	17,714	(1.0)%
Bachelor's	10,066	9,760	3.1 %
Other	1,051	1,062	(1.0)%
Total	37,786	37,588	0.5 %

(a) Enrollment in the table above includes learners who are actively enrolled during the last month of the quarters ended June 30, 2018 and 2017, respectively.

Revenues. The increase in revenues compared to the same period in the prior year was primarily related to Capella University new enrollment growth of 14.7%, in addition to Capella University weighted average tuition price increases of approximately two percent, which were implemented in July 2017. A decrease in discounts as a percentage of revenue and an increase in revenues from course resources available to Capella University learners also contributed to the increase in revenues. These increases were partially offset by a larger proportion of bachelor's learners enrolled in our post-secondary, degree granting programs at Capella University who generate less revenue per learner than our master's and doctoral learners.

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 as a result of asset

impairment charges of \$0.9 million related to capitalized internal software development costs within the Company's Job-Ready Skills segment, as well as the timing of filling academic leadership positions. These increases were partially offset by lower rent expense due to a reduction in square footage of leased office space.

Marketing and promotional expenses. Marketing and promotional expenses increased compared to the same period in the prior year, and remained consistent as a percent of revenue. The increase in marketing and promotional expenses is primarily a result of our continued investment to build brand awareness and consideration of Capella University with prospective learners

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early in their evaluation and decision process of going back to school and engaging with prospective learners as they proceed through their decision to enroll.

Admissions advisory expenses. Admissions advisory expenses, and admissions advisory expenses as a percent of revenue, decreased compared to the same period in the prior year primarily as a result of lower staffing levels in the current year period.

General and administrative expenses. General and administrative expenses increased compared to the same period in the prior year, and remained consistent as a percent of revenue. The increase in general and administrative expenses is primarily the result of increased share-based compensation expense related to a shorter vesting period for stock awards issued in the current year.

Merger-related costs. During the three-months ended June 30, 2018, the Company incurred \$0.9 million in expenses attributable to consulting, legal, and integration costs related to the proposed merger with Strayer Education, Inc.

Other income, net. Other income, net is comprised of interest income earned on cash equivalents and marketable securities, partially offset by charges related to our credit facility and management fees related to our limited partnership investments. The increase in other income was the result of higher interest income from our investments in cash equivalents and marketable securities due to rising interest rates.

Income tax expense. Our effective tax rate for the three months ended June 30, 2018 decreased compared to the same period in the prior year primarily as a result of the enactment of the Tax Cuts and Jobs Act of 2017 ("Tax Reform"), which reduced the federal corporate income tax rate from 35% to 21%.

Six Months Ended June 30, 2018 Compared to Six Months Ended June 30, 2017

The following selected financial data table should be referenced in connection with a review of the discussion of our results of operations for the six months ended June 30, 2018 compared to the six months ended June 30, 2017:

	Six Months Ended June 30, (Unaudited)		\$ Change		% Change	% of Revenue		2018
\$ in thousands	2018	2017	2018 vs. 2017			2018	2017	vs. 2017
Revenues	\$223,530	\$221,372	\$2,158	1.0	%	100.0%	100.0%	—
Costs and expenses:								
Instructional costs and services	97,782	96,781	1,001	1.0		43.7	43.7	—
Marketing and promotional	55,755	54,833	922	1.7		24.9	24.8	0.1
Admissions advisory	14,397	15,103	(706)	(4.7)	)	6.4	6.8	(0.4)
General and administrative	21,196	21,683	(487)	(2.2)	)	9.5	9.8	(0.3)
Merger-related costs	1,395	—	1,395	*		0.6	—	0.6
Total costs and expenses	190,525	188,400	2,125	1.1		85.2	85.1	0.1
Operating income	33,005	32,972	33	0.1		14.8	14.9	(0.1)
Other income, net	1,191	163	1,028	*		0.5	0.1	0.4
Income from continuing operations before income taxes	34,196	33,135	1,061	3.2		15.3	15.0	0.3
Income tax expense	8,559	11,209	(2,650)	(23.6)	)	3.8	5.1	(1.3)
Effective tax rate	25.0	% 33.8	%					
Income from continuing operations	25,637	21,926	3,711	16.9		11.5	9.9	1.6
Income from discontinued operations, net of tax	—	95	(95)) *		—	—	—
Net income	\$25,637	\$22,021	\$3,616	16.4	%	11.5	% 9.9	% 1.6

* Not meaningful.

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	June 30,			
Capella University Enrollment by Degree ^(a) :	2018	2017	% Change	
Doctoral	9,129	9,052	0.9	%
Master's	17,540	17,714	(1.0)	%
Bachelor's	10,066	9,760	3.1	%
Other	1,051	1,062	(1.0)	%
Total	37,786	37,588	0.5	%

(a) Enrollment in the table above includes learners who are actively enrolled during the last month of the quarters ended June 30, 2018 and 2017, respectively. Quarterly average total Capella University enrollment decreased 0.6% and 0.4% for the six month periods ended June 30, 2018 and 2017.

Revenues. The increase in revenues compared to the prior year was primarily related to Capella University weighted average tuition price increases of approximately two percent, which were implemented in July 2017. A decrease in discounts as a percent of revenue and an increase in revenues from course resources available to Capella University learners also contributed to the increase in revenues. These increases were partially offset by a decrease in Capella University quarterly average total enrollment of 0.6 percent as well as a larger proportion of bachelor's learners enrolled in our post-secondary, degree granting programs at Capella University who generate less revenue per learner than our master's and doctoral learners.

Instructional costs and services expenses. Instructional costs and services expenses increased compared to the prior year, and remained consistent as a percent of revenue. The increase in instructional costs and services expenses is primarily a result of asset impairment charges of \$0.9 million related to capitalized internal software development costs within the Company's Job-Ready Skills segment, as well as the timing of filling academic leadership positions. These increases were partially offset by lower rent expense due to a reduction in square footage of leased office space.

Marketing and promotional expenses. Marketing and promotional expenses, and marketing and promotional expenses as a percent of revenue, increased compared to the prior year primarily as a result of our continued investment to build brand awareness and consideration of Capella University with prospective learners early in their evaluation and decision process of going back to school and engaging with prospective learners as they proceed through their decision to enroll.

Admissions advisory expenses. Admissions advisory expenses, and admissions advisory expenses as a percent of revenue, decreased compared to the prior year primarily as a result of lower staffing levels in the current year.

General and administrative expenses. General and administrative expenses, and general and administrative expenses as a percent of revenue, decreased compared to the prior year primarily as a result of restructuring initiatives taken during the fourth quarter of 2017 in order to right-size the cost structure of the Job-Ready Skills businesses. This decrease was partially offset by increased share-based compensation expense related to a shorter vesting period for stock awards issued in the current year.

Merger-related costs. During the six-months ended June 30, 2018, the Company incurred \$1.4 million in expenses attributable to consulting, legal, and integration costs related to the proposed merger with Strayer Education, Inc.

Other income, net. Other income, net is comprised of interest income earned on cash equivalents and marketable securities, partially offset by charges related to our credit facility and management fees related to our limited partnership investments. The increase in other income was the result of higher interest income from our investments in cash equivalents and marketable securities due to rising interest rates.

Income tax expense. Our effective tax rate for the six months ended June 30, 2018 decreased compared to the same period in the prior year primarily as a result of the enactment of the Tax Cuts and Jobs Act of 2017 ("Tax Reform"), which reduced the federal corporate income tax rate from 35% to 21%.

Income from discontinued operations, net of tax. Income from discontinued operations, net of tax, for the six months ended June 30, 2017 is related to interest on the November 2016 and February 2017 deferred payments from the sale of Arden University. Beginning in the first quarter of 2016 and through the date of sale of the business, the assets and liabilities of Arden University were considered to be held for sale, and the business was presented as discontinued operations within the financial statements and footnotes.

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Analysis of Results of Operations by Reportable Segment

The following selected financial data illustrates our revenues and operating results by reportable segment for the three and six months ended June 30, 2018 compared to the three and six months ended June 30, 2017:

	Three Months Ended June 30,			Six Months Ended June 30,					
	(Unaudited)		\$	%	(Unaudited)		\$	%	
\$ in thousands	2018	2017	Change	Change	2018	2017	Change	Change	
			2018 vs. 2017	2017			2018 vs. 2017	2017	
Revenues									
Post-Secondary	\$108,538	\$106,974	\$1,564	1.5 %	\$217,723	\$216,455	\$1,268	0.6 %	
Job-Ready Skills	3,025	2,610	415	15.9	5,807	4,917	890	18.1	
Consolidated revenues	\$111,563	\$109,584	\$1,979	1.8 %	\$223,530	\$221,372	\$2,158	1.0 %	
Operating income (loss)									
Post-Secondary	\$18,029	\$17,754	\$275	1.5 %	\$37,473	\$38,005	\$(532)	(1.4) %	
Job-Ready Skills	(2,077)	(2,383)	306	(12.8)	(3,073)	(5,033)	1,960	(38.9)	
Merger-related costs	(873)	—	(873)	*	(1,395)	—	(1,395)	*	
Consolidated operating income	15,079	15,371	(292)	(1.9)	33,005	32,972	33	0.1	
Other income, net	695	56	639	*	1,191	163	1,028	*	
Income from continuing operations before income taxes	\$15,774	\$15,427	\$347	2.2 %	\$34,196	\$33,135	\$1,061	3.2 %	

* Not meaningful.

Post-Secondary. Post-Secondary segment revenues increased by \$1.6 million and \$1.3 million, or 1.5 percent and 0.6 percent, respectively during the three and six months ended June 30, 2018 compared to the three and six months ended June 30, 2017. The increase in revenues for the three and six month periods was primarily attributable to weighted average tuition price increases of approximately two percent, which were implemented in July 2017. For the three month periods, an increase in Capella University new enrollment growth of 14.7 percent and total enrollment growth of 0.5 percent also contributed to the increase in revenues, while a decrease in Capella University quarterly average total enrollment of 0.6% partially offset the increase in revenue for the six month periods. For the three and six month periods, revenue was unfavorably impacted by a larger proportion of bachelor's learners enrolled in our post-secondary, degree granting programs at Capella University who generate less revenue per learner than our master's and doctoral learners.

Operating income for the Post-Secondary segment increased by \$0.3 million, or 1.5 percent for the three months ended June 30, 2018 compared to the three months ended June 30, 2017. For the six months ended June 30, 2018, operating income for the Post-Secondary segment decreased by \$0.5 million, or 1.4 percent compared to the six months ended, June 30, 2017. The increase in segment operating income for the three month periods was primarily attributable to a decrease in instructional costs and services expenses primarily as a result of lower rent expense due to a reduction in square footage of leased office space, in addition to a decrease in admissions advisory expenses arising from lower admissions staffing levels in the current year period. The decrease in segment operating income for the six month periods is primarily attributable to an increase in marketing and promotional costs arising from investments in marketing campaigns to increase the awareness and consideration of the Capella University brand with prospective learners and articulating Capella's differentiation to employers in an effort to generate new enrollment.

Job-Ready Skills. Job-Ready Skills segment revenues increased by \$0.4 million and \$0.9 million, or 15.9 percent and 18.1 percent, during the three and six months ended June 30, 2018 compared to the three and six months ended June 30, 2017. The increase in revenues during the three and six months ended June 30, 2018 is primarily attributable to increased enrollments at DevMountain during the first and second quarters of 2018.

For the three and six months ended June 30, 2018, the operating loss for the Job-Ready Skills segment decreased by \$0.3 million and \$2.0 million, or 12.8 percent and 38.9 percent, respectively, compared to the three and six months ended June 30, 2017. The decrease in the operating loss is primarily the result of restructuring initiatives taken during the fourth quarter of 2017 in order to right-size the cost structure of the Job-Ready Skills businesses. The overall decrease in segment operating loss for the three and six month periods was partially offset by asset impairment charges of \$0.9 million arising from the write-off of previously capitalized internal software development costs related to software projects within the Job-Ready Skills segment.

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Liquidity and Capital Resources

Liquidity

We financed our operating activities and capital expenditures during the three and six months ended June 30, 2018 and 2017 primarily through cash provided by operating activities. Our cash and cash equivalents were \$117.9 million and \$106.6 million at June 30, 2018 and December 31, 2017, respectively. Our cash and cash equivalents increased primarily due to cash provided by operating activities and maturities of marketable securities, partially offset by cash used in investing activities for purchases of marketable securities and capital expenditures as well as cash used in financing activities for the payment of dividends.

On December 18, 2015, the Company entered into a secured revolving credit facility (the Facility) with Bank of America, N.A., and certain other lenders. The Facility provides the Company with a committed \$100.0 million of borrowing capacity with an increase option of an additional \$50.0 million. The Company's obligations under the Facility are guaranteed by all existing material domestic subsidiaries and secured by substantially all assets of the Company and such subsidiaries. The Facility expires by its terms on December 18, 2020. As of June 30, 2018 and December 31, 2017, there were no borrowings under the credit facility, and the Company was in compliance with all debt covenants. The Company will terminate the Credit Agreement upon completion of the Merger with Strayer Education, Inc.

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 February 8, 2016, the Company's Board of Directors approved a plan to divest Arden University. On August 18, 2016, the Company completed the sale of 100% of the share capital of Arden University for a sale price of £15.0 million, of which £11.5 million (\$13.9 million net of acquisition-related fees) was paid in cash at closing, with an additional £1.0 million, or \$1.3 million, paid on November 15, 2016, and the remaining amount due of £2.5 million plus interest, or \$3.2 million paid on February 28, 2017.

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 from continuing operations was \$39.4 million and \$36.2 million for the six months ended June 30, 2018 and 2017, respectively. The increase was primarily due to an increase in net income as well as changes in operating assets and liabilities, including an increase from accounts payable, partially offset by a decrease from income taxes payable.

Investing Activities

Net cash used in investing activities from continuing operations was \$7.7 million and \$5.9 million for the six months ended June 30, 2018 and 2017, respectively. In the current year, net cash used in investing activities consisted of purchases of marketable securities, capital expenditures related to investments in property and equipment, and

investments in partnerships, partially offset by maturities of marketable securities. Net purchases and maturities of marketable securities resulted in cash inflows of \$2.2 million and \$6.5 million during the six months ended June 30, 2018 and 2017, respectively.

We believe the credit quality and liquidity of our investment portfolio as of June 30, 2018 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.

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Investments in limited partnerships were \$0.8 million and \$0.4 million during the six months ended June 30, 2018 and 2017, respectively. The Company has committed to contribute an additional \$3.2 million to its limited partnership investments through September 2027, which is expected to be funded from cash provided by operations and the timing of which is uncertain.

Capital expenditures were \$9.1 million and \$12.1 million for the six months ended June 30, 2018 and 2017, respectively, which primarily consisted of investments in foundational infrastructure, the development and refinement of courses, and learner support and prospect experience initiatives.

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 from continuing operations was \$20.3 million and \$9.1 million for the six months ended June 30, 2018 and 2017, respectively. Cash payments of dividends were \$15.1 million and \$9.5 million for the six months ended June 30, 2018 and 2017, respectively.

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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 our investment policy, which focuses on capital preservation and liquidity. In addition, all investments must have a minimum credit 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 minus or higher as of June 30, 2018 and December 31, 2017, by at least one rating agency. In addition, the Company utilizes money managers who conduct initial and ongoing credit analysis on our 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, we 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 June 30, 2018, 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.

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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 June 30, 2018, 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, 2017.

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 six months ended June 30, 2018, the Company repurchased no common stock under its share repurchase program. Its remaining authorization for common stock repurchases was \$27.0 million at June 30, 2018. The Company announced its current share repurchase program in July 2008. As of June 30, 2018, the Company's Board of Directors has authorized repurchases up to an aggregate amount of \$335.7 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	<u>Amended and Restated Articles of Incorporation.</u>	Incorporated by reference to Exhibit 3.1 to the Company's Current Report on Form 8-K filed with the SEC on November 20, 2006.
3.2	<u>Second Amended and Restated By-Laws.</u>	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	<u>Specimen of common stock certificate.</u>	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 20, 2006.
31.1	<u>Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.</u>	Filed electronically.
31.2	<u>Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.</u>	Filed electronically.
32.1	<u>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.</u>	Filed electronically.
32.2	<u>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.</u>	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.

* Management contract or compensatory plan or arrangement.

(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

August 1, 2018

J. Kevin Gilligan

Chief Executive Officer

(Principal Executive Officer)

/s/ Steven L. Polacek

August 1, 2018

Steven L. Polacek

Senior Vice President and Chief Financial Officer

(Principal Financial and Accounting Officer)